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ECONOMIC SURVEY

Moldova in Transition

1

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FOREWORD

The first issue of the Economic Survey: Moldova in Transition, submitted to your attention has been conceived by its authors as a research monitoring (analysis-forecast) publication of the national economy.

Economic Survey is aimed at filling in the almost empty niche - between the dispassionate materials of the Department of Statistical and Sociological Analysis and actively emotional publications in mass-media. The idea emerged within the UNDP/WB project Strategy for Development (Center for Strategic Studies and Reforms, NGO), with the support of other projects, under implementation in the country, including agencies ARIA, ARA, TACIS Moldovan Economic Trends, USAID Western NIS Enterprise Fund.

The timing of the publication is at critical points of the year - at the beginning (evaluation of the previous year, forecast for the next year); based on the results of the first semester, during the work on the economic forecasts, and budget for the next year; in the fall, when a good deal of the year is over and the trend and problems requiring adjustment are mostly evident. It is not less important the experience of other countries in transition, particularly the close neighboring ones.

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Any cooperation will be welcomed.

**CHAPTER 1. SOCIAL ECONOMIC OVERVIEW: CURRENT
SITUATION, SHORT-RUN OUTLOOK**

The Republic of Moldova entered 1998 with a heavy burden of the social, economic and financial problems. Regardless to the discreet optimism concerning the results of the previous year (1.3% growth of GDP, 11.2% of annual rate of inflation, 0.3% devaluation of the national currency, 5% rise of real incomes of the population, diminishing arrears for wages and pensions), there are enough symptoms, that macrostabilization - the basic achievement of the initial stage of reform - is still vague, being caused by the delayed structural reforms in the real economic sector, incomplete restructure of the entire state administration system, as well as by the impact of the non-economic factors upon the situation in the country.

It is quite possible, that *1998/99 will be an even more critical period for the country in this decade*. The sharp decline of production output and social standards of the early '90-s were offset by "gobbling" previous accumulated national wealth, then, starting from 1996, the economy of Moldova got on the path of stable depression, of depleting resources, gradual cease of operations of the industrial production capacities, degrading raw material basis for foodstuffs production, stagnating R&D, population aging and health state worsening, destruction of social infrastructure as a system.

Moldova ranks among the last 1/3 of those 130 countries of the world in terms of GNP volume (US\$ 2.3-2.5 billion, including Transnistria), below the 90th place, while in Europe it ranks together with Albania and Macedonia among countries with lowest incomes. Living standards indicators: men's average life (62 years) and women's (70), as well as the energy resources consumption per capita in Moldova is below the world average. The country's annual expenses for education and medicare is less than 3-5% of the GNP, as compared with expenses volume of the most European countries (1998 World Development Indicators. World Bank, March 1998). Nevertheless, *market transformation in the Republic of Moldova is irreversible*. Of 26 countries in transition, Moldova ranks in the middle in terms of liberalization of enterprise operations, prices and trade, privatization, inflation, legal basis and institutional structures of the market economy (Transition Report 1997. European Bank for Reconstruction and Development). In line with that, there is noticeable a lack of stability: the state budget deficit, constant tax arrears, chronic salary and pension arrears, non-payments and low profitability of most industrial enterprises, latent unemployment, state machinery corruption and, the state power is weak in providing for public order in the country. All these problems stem from the need to restructure the national economy, starting from enterprises up to its key sectors – agriculture, energy, industry and social sphere. For this purpose legal basis are required, investments, entrepreneurship and restructuring of privatized enterprises support, their profitability and competitiveness enhancement, export promotion.

Unfortunately, after the "big leap" towards market economy, undertaken by the Parliament and Government in 1993-1995, the pace of reforms was subsequently throttled back. If previously the "Economist" (March, 1995) wrote: "Moldova is the model of sound reforming, its compactness makes it a perfect laboratory of reform", afterwards, after a series of unsuccessful investment tenders ("Tutun", Cement Works from Rezina, "MoldTelecom"), repeated manifestation of "special interests" and fast extension of shadow economy, the image of the country faded away.

Already now the *shortfalls and mistakes of transition period* are evident: insufficient social compensation of reforms, procrastination of Civil Code adoption and incompleteness of legal base for reforms, non-respect of laws, low economic efficiency of state property privatization, delayed restructuring of industrial enterprises, including bankruptcy procedure, contradictory actions in agrarian sector (periodical cancellation of large farms' debts, slow land reform), energy complex monopoly, lack of state policy in employment, inadequate new conditions of the economic basis of the local-self administration.

The assumed predictions of immediate economic growth “in 1.5-2 years” after realization of macroeconomic stability did not become reality. The same failures occurred in other aspects: cutting down state expenditures, speeded up privatization, domestic market openness, etc. Year by year the state costs keep being “curtailed”, whereas the difficulties of budget execution are growing. A good deal of state property has been already privatized, yet, the private sector output in terms of taxes and budget revenues is rather modest. The openness of the domestic market filled the country with low quality goods, including food items. The economy liberalization released from control the actions of the enterprises’ senior management. Most functions of the sectoral ministries have died away, while the territories (municipalities, raions) have not been assigned due rights and resources. This is why the question arises of the role and responsibility of the state as initiator of reforms.

The Republic of Moldova is a new state of Europe, with unconsolidated laws, institutes and procedures of political economic and public life. And, unfortunately, amongst main reasons of stagnation delay is the permanent political and economic uncertainty, particularly manifested during pre- and post election periods, in conditions, when in the country the generally accepted strategy of the social-economic development and clear definition of procedure of working out its legal and management decisions are still missing. The interests of the country might be fully provided through a “cycle of political stability” in 1998-2000, when the long-run cooperation between the President, Parliament and the Government could considerably push Moldova towards reaching its strategic targets (Republic of Moldova: Key Problems and Strategic Priorities for National Economic Development. CISR, Chi°inãu, July 1997).

Proceeding from the real situation, *the majority right-centrist wing of the Parliament and their created Government, in May 1998, adopted a rather radical action program for 1998-2001*, including as priority measures on financial recovering, restructuring of production sector and social sphere.

Budget sphere recovering. For the purpose to overcome the crisis in the budget system, the Government will focus its efforts on:

- Enhancing efficiency of tax collection to the budget, first of all by diminishing and ceasing mutual settlements, providing primarily for cash inflows;
- Primary expenditures from the state budget are defined: payment of pensions, wages (including arrears) and compensations to the population; serving the state indebtedness; payment of expenditure arrears for energy resources; payment of medicines and foods for social sphere institutions (hospitals, ambulances, special schools, and others).

Energy sector restructuring. The Government will undertake measures to prevent financial bankruptcy of the given sector and to make it attractive for investors, through:

- Immediate adoption of legal and normative basis that regulates the activity of the energy sector in market economy conditions;
- Demonopolization, restructuring and privatization, creating adequate conditions in the manufacturing sector, transportation and distribution of energy resources;
- Improving the mechanisms of settlement of tariffs for electrical, thermal power and gas;
- Modification of privileges system;
- More ample collection of cash payments from companies and population for energy resources, by excluding mutual payments and settlements in kind.

With the purpose to develop the privatization program for 1997-1998, on June 25, 1998 the new Parliament adopted the concept of energy complex enterprises restructuring.

Agrarian reform. Considering the primary importance of the agri-industrial complex in the national economy and the need to enhance the effectiveness of reforms in this field, the Government will undertake measures in:

- Completion of land reform;
- Creation of land market, based on law;
- Suppression of “special interests” manifestations, that generate shadow economy, corruption and crime.

Privatization. The Government will undertake measures in removing the barriers, constraining the implementation of law “On privatization program on 1997-1998”, setting as cornerstone not only the budget interests, but also the emergence of the real proprietor, as well as attraction of investments. A particular attention will be paid to suppressing any illicit participation of state office holders in privatization process.

Social sphere reforms. Proceeding from the need to diminish the social cost of reforms and considering the financial possibilities of the state, the Government designs to:

- Determine the minimum set of social services, guaranteed by the state, and provide them to most needy layers of population;
- Carrying out the pensioning reform through introduction of respective amendments into legislation;
- Introduction of alternative forms of funding social services (medicare, education and others).

The anti-crisis measures adopted by the Government from the very first month of its activity (June 5, 1998), joined together the actions in the fiscal-budgetary system and in consolidating the financial basics of the social sphere.

The ground for this was a serious reason: *by the end of first half of 1998, the state budget in fact broke down.* Budget revenues have been collected only at 33% of the previously foreseen collections for the first half year (of that about 60% accounted for revenues from indirect taxes), the revenues of local budgets sharply declined, accounting for only 27% of the overall revenue of the consolidated budget. The greatest share of budget expenditures (over 50%) have been channeled unto three directions: current payments and paying-off salary arrears; purchase of energy resources and state debt servicing.

On June 29, 1998, the Government approved and submitted to the Parliament for consideration the amendments to the 1998 Budget Law, ensuring the foreseen level of revenues on the account of tax collections, increase of excisable goods’ list, sale of state property, etc., and this way to reduce, in line with that, its expenditures (by US\$ 7.4 million) which triggered off a decline of budget deficit (by US\$ 7.4 million). The amounts were diminished of state guaranties for foreign loans (from US\$ 35 million to US\$ 9 million), capital investments, expenses for agriculture, transport, communications and municipal economy. It was decided also to reduce the disbursements from state budget to Social Fund by 40%, which will entail costs reduction for compensation of electricity, heating, gas and pension transfers. As stated by the Prime-minister I. Ciubuc, “suggested measures are a serious surgery operation, but there is no way out.”

It is obvious that an implicit result of excises increase on gasoline and diesel, as well as elimination of TVA exemptions for dairy products and bread, will generate a general increase in prices by about 10-15%, including by 20-25% for bread and dairy products. This measure will certainly finalize the process of price liberalization for those products, but, on the other hand, extremely negative reactions from the population are inevitable.

Indeed, the Government has no more popular leverage, the variants of possible actions are less and less, because most of the anti-crisis measures have not been directed to activation of production, where from the economic growth should actually start from, but to averting the country’s insolvency.

The social-economic policy of the Government goes through a narrow corridor, along which most dangerous is the “debtor’s prison”, built up by its predecessors. *The external debt* of the country as of January 1st, 1998, amounted to about US\$ 1.3 billion (65% of GDP), and after the beginning of the year it continued to grow, basically on the account of energy resources. That critical level of debt was reached due to ineffective usage of foreign borrowings from abroad. Suffice it to say, that in 1994-1997 from 30 to 60% of the budget deficit was covered by means of foreign loans and credits. They were taken with the hope, that by the time when the state debt will reach a hazardous threshold, the economy will eventually activate, that the taxes inflow will rise, and, respectively funds for reimbursing the loans. However, by mid 1998 none

of the mentioned above occurred. Meantime, if during 4 recent years the debt servicing took almost US\$ 300 million, in 1998 will be required US\$ 215 million, and in 1999 – US\$ 235 million, under conditions of rather limited possibilities of getting assistance from abroad.

Regardless to the evident internal and external *threats of financial stability*, thanks to a highly professional approach of the National Bank (NBM), Moldova succeeded to up-keep in general, until very recently, a stable exchange rate of the leu, sufficient volume of forex reserves and a relatively low rate of bank credit (17% as of May 1998).

By mid 1998, however, the situation changed. Ministry of Finance borrowed “big money” on the domestic market, which entailed their shortage with the commercial banks. In June there was held, probably, the last credit means’ auction (refinancing rate rose to 22.5%) and the NBM stated its intention not to hold auctions in the future and shift to purchase-sale operations of short-run state liabilities.

Questions were also generated in relation with the securities auctions (Treasury Bills and Bonds), held by the Ministry of Finance. In order to settle them in the first half year of 1998 the Ministry of Finance paid incomes amounting to 57.5 million lei and, until the year end, in case the T-bills will keep being so profitable (32% per annum), their redemption will cost about 150 million lei. There is a paradox: the state securities market altered from a fund supplier for budget deficit alleviation into an antipode – a negative balance emerged on T-bills’ payment and sale. High profitability of T-bills, on the one hand, and “firmness” of Moldovan leu, on the other (during January-May it devalued by less than 1%), generate uncertainties on: whether the forthcoming settlement of state securities will be delayed or, national currency will devalue.

So far the NBM warns against that dramatic conclusion, yet, the entrepreneurs, investors and population require clearer guidelines concerning leu’s exchange rate position until the end of the year.

The situation created in the financial sector has a negative impact on the formation in Moldova of a domestic *investment system*, as well as on the inflow of capital from abroad. Creating conditions for investment inflow, first of all into the real economy, is the utmost importance long run task - it should also be taken into account in terms of its importance for renewing technologies and exports, generation of new jobs, increasing incomes of the state and population. The peak of direct foreign investments (US\$ 64.0 million) occurred in 1995, then followed a two year decline. In the 1st quarter of 1998 investments amounted to US\$ 15.9 million; subsequent expectations are linked to the sale of “MoldTelecom”, Cement Works from Rezina and other perspective enterprises and foreign companies’ involvement in infrastructure restructuring – energy sector, water supply system, hotels, tourism, etc. More than 1.3 thousand joint-ventures are registered in the country (with foreign capital worth US\$ 146.0 million, or 58% of the overall), however their indicators are very modest in terms of employees (15 thousand) and export share (12%).

The situation can, and should be improved. Most important actions, that can have a positive impact upon the investment environment in the 2nd half year of 1998 are: demonstration of a political will by the Parliament and Government to move the problem from the deadlock, tender transparency and suppression of “special interests”, support of certain regions’ (Chi’inău, Bălți, Gagauzia) and enterprises’ initiatives. Investment inflow can be opposed by some attempts to revise and cancel privatization results, state machine’s strive to “keep under control” profitable objects, discrepancies related to land market development, artificially maintained status of “missing real owner” at the enterprises in the post-privatization period.

Political will of the new Parliament towards reforms will be displayed already in July, since the President P. Lucinschi made an appeal suggesting to urgently adopt the amendments to the state Budget Law on 1998, the law on pensions and a packet of laws on administrative-territorial reform. Shouldn’t this occur, the Parliament and Government will hardly make the year of 1998 a turning point, in terms of putting the country on the way of sustainable development, although both right-centrist majority and opposition keep declaring their strive to do so.

Even if the opposition does not count on a long “longevity” the current Government, the Parliament cannot afford to lock itself in one year cycle governing of the country: elaboration of the annual program, budget law adjustment in the middle of the year, and eventually – promises to start economic growth from the next year, etc. In a series of countries, for instance, there is a practice of budget-fiscal planning on three year basis, in connection with a forecast of economic growth, inflation tempo, refinancing rates, and other indicators. They are adjusted on yearly basis, in compliance with changes in the economic conjuncture, government policy, etc.

It would be arguable to consider, that the social and financial problems of the Republic of Moldova aggravated in 1998 only because of unconditional fulfillment of IMF and WB recommendations. In part, this is justified as regards the pace and methods of “popular/mass privatization”, rejection of protectionism, in weakening the role of the state in managing the transition period. One of the main reason of the created situation, is lack of long term action plan and succession in the governments’ actions, prevalence of tactical decisions related to “burning questions”. There were attempts to develop middle-term strategy of the social economic development of the country, however, they haven’t been formally recognized (*Strategy of the National Economy of the Republic of Moldova Till Year 2000* (Draft). Ministry of Economy. Chiºinu, 1996; *Strategy of Social and Economic Development of the Republic of Moldova During the Period Till Year 2000*; Center for Market Problems Research, Academy of Sciences of Moldova, and Ministry of Economy. Chiºinu, 1996; *Republic of Moldova: Strategy for Development*. Center for Strategic Studies and Reforms. Chiºinu, January 1998). A fundamental question is still unsettled, regarding the *coordination of market liberalism and regulatory role of the state*. Particularly it is meant, the state regulatory system of strategic development of the economy of the country. The state ownership of production means should be substituted by the right of the state to guide the strategic development of the country.

Taking into account all these circumstances, it is high time, when 1998/99 is a critical period for the fate of the of the country, that the Parliament and the Government undertake the complex of actions with cumulative, long-term effect in the main fields:

real budget, fiscal stabilization and control of arrears;

post-privatization restructuring of not less than 100-120 enterprises of the key industries (financial recovering, management improvement, attraction of investments, enhancement of competitiveness);

land reform and restructuring of agricultural enterprises - over 700 farms, land market development and of a system of lending to infrastructure and servicing new types of agri-businesses;

reorganization of *energy sector* – privatization and decentralization of manufacturing sector, transportation and distribution of energy (Moldenergo, Tirez Petrol, Termocom), revision of tariffs for consumers;

enhancement of economic and social results of *privatization*, sale of enterprises for cash and of land plots under privatized enterprises;

social sector – two priorities: revision and alteration of social protection system (in favor of needy social strata, with a view to eliminate the debts to the population from state budget); performance of pension reform.

Besides those issues, typically discussed by the Government with IMF and WB, there at least two more problems, requiring constructive efforts of the Presidency, Parliament and Government, are: (i) *reorganization* and enhancement of effectiveness of the *state machinery*; (ii) *administrative territorial reform*, federalization of budget and shifting to local *self-administration*. The argument favoring the urgent solution of those issues are evident: Moldova is a new state, the administration system is weak and ineffective, which is directly reflected in its corruption and involvement in informal economy. In new conditions, when the economic agents are independent and the methods of branch based management (basic in soviet economy) have died, the role of territories should be enhanced (municipalities, raions). Without a needed legal basis, sufficient incomes to local budgets and municipal ownership, the social and

economic reserves of the territories won't be effectively used. And now they are also mostly involved in shadow economy. In addition to that, only based on economic grounds and European standards of local self-administration ultimately there can be resolved the problems of Transnistria and Gagauzia.

Thus, judging by the results of the first half year of 1998 of the social-economic development of Moldova, there are nor substantial positive trends. The CISR forecast (Dec. 1997) of a 3% GDP growth in the current year, according to the results of the first half-year, probably will be adjusted to lessening. The emerged some expectations at the beginning of the year, related to recovering from the stagnation and turning to a positive economic trend, was not justified. Moreover, threat emerged in the financial sector. The economy is still "hanging-on" on the edge of "fall or rise", and its further orientation depends on the coordination of the President, Parliament and Government, on the political situation in the country. Its stability will undoubtedly contribute to economic ice-braking. And conversely, continuation of political uncertainty, particularly its aggravation, will aggravate the economic situation and living standards of the population.

CHAPTER 2. MACROECONOMIC TENDENCIES

The year 1998 will be year of big endeavors, including tough acceptance of the simple truths of economic realities such as: that we can not consume without paying; nobody is willing to support or to credit someone else forever; it is impossible to continuously accumulate external debt without having the capacity to reimburse it; market mechanisms imply revenue distribution according to individual and group performance; unity and social solidarity are easier to realize in a society which is doing well; in open systems performances are estimated in relative terms (it is important not only what we are doing, but what our neighbors are doing).

2.1 Budget and fiscal policy

2.1.1 State budget and public finance

During the last 2 years budget and fiscal policy has been in the center of social and economic life of Moldova. Acute social and economic problems are the result of delays in structural reforms, inefficient public finance spending, which is used only for covering current state's expenditures (wages, pensions and their arrears, public debt servicing). But even these positions are under financed.

There are some internal constraints in the Republic Moldova which impede a stimulatory fiscal policy for the productive sector of economy. This sector should become a catalyst of economic development for the near future. These constraints are the following: **political constraint** (uncertainty linked with Transnistria region, or low viability of executive bodies); obsolete **social infrastructure**, having a low efficiency and high costs, which is actually waiting for budget allocations only; **external and internal state liabilities** related to public debt servicing; **significant share of shadow economy** which is tending to take under control the activity of economic entities, in both private and public sectors.

The insufficiency of public finance is caused by a number of factors, the main being:

- state's integrity problem, and non-existence of clear borders, with specific attributes (such as customs etc.). This results in imports of goods with no excises paid;
- significant and increasing share of shadow economy as share of GDP, as well as of tax evasion;

- limited transparency of the tax system in Moldova, having a large list of tax exemptions applied to the main budget revenue sources;
- corporate interest for tax forgiveness;
- big number of payments in kind, as well as of netting out in the transactions between economic entities and with the budget;
- inefficient and non transparent usage of financial sources, which are already insufficient (especially for energy resources, medicines, subventions).

In spite of achievements in 1997 regarding tax collection (the budget was realized at 110% comparing with the approved one), the problem of budget deficit still remains quite actual.

The budget deficit, which amounted to 692 million lei, or 8% of GDP (preliminary data), had a trend of increasing, comparing to 1996.

Dynamics of budget indicators (in million lei)

	1995	1996	1997	I Q. 1998**
Revenue, including Social Fund	2556	2835	3473	518.4
as % of GDP	39%	37%	40%	
Expenditure, including Social Fund	2993	3418	4165	546
as % of GDP	46%	45%	48%	
Deficit, including Social Fund*	437	583	692	27.6
as % of GDP	7%	8%	8%	
GDP	6480	7658	8655	

* - according to Public Finance Statistics and new Budget Classification

** - excluding Social Fund

The increase in budget revenues in 1997 was achieved mainly due to:

- huge number of netting out transactions (about 37 percent);
- non fiscal revenues, such as military equipment, which were not initially included in the budget;
- increase of excise tax rates for petrol products;
- insignificant improvement of tax administration (due to enforcement of the Law No. 633, however the costs resulted from implementation of this Law are very high).

During the 1st quarter of 1998 comparing to the same period of 1997 tax collection to both state and local budgets is as follows:

1 st quarter	1997			1998		
	state budget	local budgets	consolidated budget	state budget	local budgets	consolidated budget
TOTAL REVENUE	305596.5	160555	466151.5	394832.6	124112	518944.6
1. Current revenue	302588.8	157963	460551.8	380250	119159	499409
1.1 Fiscal revenue	222214.2	138125	360339.2	265985.2	98194	364179.2
1.2 Non fiscal revenue	80374.6	19838	100212.6	114264.8	20965	135229.8
2. Capital revenue	3007.7	2592	5599.7	14582.6	4953	19535.6

As it is presented above, a diminishing trend in tax collection is recorded at local budgets. These reductions are mainly coming from the income tax and property tax, which have decreased in absolute amount.

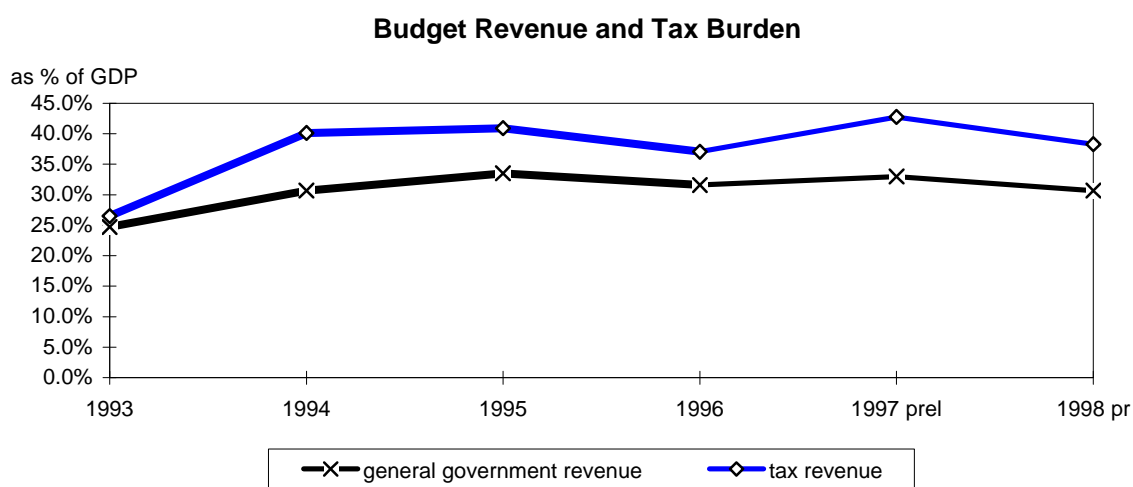
Tax burden. In spite of all achievements in tax collection in 1997, there still exists one negative aspect. And if the said achievements are for a short term period, then the negative aspect could have effects throughout a medium term period. The problem is the tax burden increase in the Republic of Moldova, and this increase is quite important if comparing to the

evolution of this indicator during 1993-1996. But if we would take into account the grown number of tax exemptions, especially in 1996-1997, then we conclude that the tax burden is not distributed fairly through the sectors of economy. Moreover, even within some particular sectors the tax burden is not distributed equally between economic entities.

Budget Revenue and Tax Burden

	1993	1994	1995	1996	1997 <i>prel</i>
General Consolidated Budget Revenue, mln. lei	488	1847	2556	2835	3473
As % of GDP	27%	39%	39%	37%	40%
Tax Revenue, including Social Fund, mln. lei	450	1454	2171	2418	2857
Tax Burden, %	24.7%	30.7%	33.5%	31.6%	33.0%
GDP in current prices, mln. lei	1821	4737	6480	7658	8655

Note: in 1993 the above indicators as a share of GDP are not relevant, because the volume of GDP in current prices is much more “sensible” towards the level of inflation, comparing to budget revenue.



Some conclusions should be made from the above said:

- in spite of statistical data, indicating that private sector share in goods production and services is increasing, the state had an expanding role in the GDP distribution in 1997. This could generate a new substitution of private sector by public sector;
- tax burden in 1997 increased by 2.4 percentage points comparing to 1996. WE refer here to the general tax burden in the economy, but some sectoral calculations (N. Culeabin, Institute of Economy of the Academy of Sciences) prove that in several sectors (such as the industry) tax burden reaches almost 60 percent. Inadequate sector distribution of tax burden was generated by a lot of tax exemptions given to some branches or some economic entities, by “forgiving” of some liabilities, and by rescheduling the payables to the budget of certain economic entities etc. – all these under the conditions of growing needs of public sector;
- the growing tax burden and/or fast extension of corruption and protectionism generated in 1997 an increase of turnover in shadow economy, and respectively of the tax evasions. Thus, by increasing the excise taxes on gasoline (by 3 times) and diesel (by 2 times), a growth of income was expected at the same rate. But they were lower, because of inefficient control over the import of such products and lack of customs facilities at the borders with the Ukraine (or with Transnistria). The same is the situation with tobacco products imports: according to the Law on Budget for 1998 excise taxes on cigarettes have been reduced and unified. According to economic laws a drop in retail prices in the market was expected, but that did not

happen. Consequently, the cigarettes' importers received huge profits, while the budget is still losing on that.

Analysis of the retail prices structure of the petrol products and tobacco products shows that in Moldova the excise rates for these items are amongst lowest, compared to several developed countries and neighboring countries.

Out of this consideration, we are supporting the increase (up to the level of 1997) of import excises for gasoline and diesel, as well for tobacco products, no matter which their country of origin is.

It is clear, that the need for *reducing budget expenditures* is imperative, and there is some room for maneuver here:

□ reform of public administration, both central and local. It is impossible to maintain such over-staffed state apparatus, which can be characterized as inefficient, low paid and sometimes *morally obsolete*. Regretfully, the hopes that the structure of Government will be revised, and personnel – reduced, can not be realized after the new Government structure was approved already.

In the GDP structure public consumption is increasing, in spite of the decreasing role of state in the economy. This seems to be a paradox.

GDP structure by consumption
(as % of GDP)

	Final consumption				GFCF		Exports		Imports	
	Private		Public							
	1990	1995	1990	1995	1990	1995	1990	1995	1990	1995
Bulgaria	54.1	70.3	19	15.5	18.2	14.2	43.5	44.7	39.2	44.9
Czech R.	50.6	57.8	19.4	19.5	28.6	28	...	51.1	...	56.3
Cyprus	60.1	60.3	17.4	16.5	24.7	19.9	51.6	46.6	57.1	53.4
Estonia	64.4	58.1	13.2	23.8	30.2	25.6	...	75.8	...	84
Hungary	54.8	54	35.7	24	20.9	19.1	32.8	34.4	33.7	36.6
Latvia	52	59	8.8	20.3	23	16.6	47.9	47.3	49	49.4
Lithuania	54.9	69.5	11	19.8	28.8	21.4	54.2	53.6	63	65.4
Moldova	40.4*	69.9**	15.5*	25.9**	15.5*	19.8**	39.6*	53.9**	51.3*	74.1**
Poland	48.5	63.1	18.7	17.6	21	16.9	28.6	25.9	21.5	24.6
Romania	65.9	68.6	13.3	12.2	19.8	21.9	16.7	27.8	26.2	33
Slovakia	53.9	49.3	21.9	20.3	31.3	29.4	...	63.5	...	61.7
Slovenia	53.2	57.9	17.4	20.2	18.8	21.2	90.8	54.2	78.5	55.5

* - for 1993

** - for 1996

GFCF – gross fix capital formation

As it is presented above, countries which have reduced public consumption and promoted structural reforms became more efficient (for example Hungary, Poland, Slovakia).

□ Reform of social protection system and social *benefits*, which have not been restructured yet. What is meant here is the approval of the respective legal framework and its implementation;

□ Military bodies reform;

□ Implementation of a transparent mechanism of public procurements.

If these reforms continue to be delayed in 1998, then the period of 1999-2000 is coming, when budget expenditures for debt servicing will be at a critical point, and nobody would know how to “save” the country.

Wages and pensions arrears. The problem of arrears on wages and pensions remains to be the main problem of 1998, as it was in 1997. As of January 1, 1997 the arrears have been frozen and the payment schedule was approved. Thus, population served as a Government creditor during 1997, and the Government was a beneficiary of this “preferential” credit, without any interest and maturity, and real sources for repaying it.

Although by the end of 1997 the arrears were diminished down to 90 million lei, through other loans (especially from international financial organizations and borrowing on external markets), the arrears as of May 1, 1998 increased considerably, for pensions – up to 230 million lei, for budget wages – up to 150 million lei.

It is not clear where the funds for increasing wages by 30% for budget employees (according to government’s decision No. 231, March 1998) will be taken from. It is crucially needed to abrogate this decision, in order to avoid worsening of the situation of arrears.

At the same time, for the first quarter of 1998 the budget revenue is lower comparing to the forecast. External financing is quite limited, and internal borrowing is more expensive for the budget, also having a negative impact on banks’ interests rates.

One question arises: where will the government be getting the money from, or which expenditure account should be cut down?

It is vital to sequester budget expenditure.

Budget deficit and public debt. The level of public debt and state’s capacity to service it are very important issues in describing the financial situation of the state.

It is clear from the very beginning that the approved level of budget deficit of 350 million lei will be exceeded (under the conditions of revenue shortage and arrears at almost all expenditure items) just because the infrastructure of budgetary institutions as well as their functions remained unchanged. Anyway, in the end it is not that figure, but the *primary budget balance* which is most important for an adequate policy regarding deficit and public debt management. Primary balance shows if during the year new borrowing was or wasn’t used for financing current expenditures.

Based on budget indicators evolution during 1994-1997, we can see that although the tendency for approving a positive primary balance persists, at the end of fiscal year the situation goes vice-versa. And the authorities’ efforts to manage the public debt and to diminish total amount of public debt will not be successful, unless during the next 5-7 years a positive primary balance with an upward trend is not achieved.

The evolution of budget balance (million lei)

	1994		1995		1996		1997		1998	
	<i>approved</i>	<i>actual</i>	<i>approved</i>	<i>real</i>	<i>approved</i>	<i>actual</i>	<i>approved</i>	<i>actual</i>	<i>aprobat</i>	<i>est</i>
Overall balance	-241.5	-280.3	-300	-374	-350	-752	-330	-666.7	-350	-550
Debt service	109	118	180	265.2	250	242.8	379	377	450	430
Primary Balance	-132.5	-162.3	-120	-109	-100	-509	49	-289.7	100	-120

Note: “-” sign represents a deficit

* - in 1994-1996 according to the methodology of the Ministry of Finance

With all respect towards the sustained efforts of creating and strengthening, during 1995-1997, the internal financial market, mainly T-bills, still, it is necessary to limit the state's presence in the internal market. In case of Moldova the state should implement a policy of securities' issuance within the amount needed for repurchasing existing Treasury Bills and Bonds. As a result of this policy, the internal debt will not increase, which according to the Budget Law for 1998 could increase by another 320 million lei. In case when the state will not borrow that amount – it could be available for economic entities at lower interest rates. And this would stimulate an increase of economic activity.

It is well known that external financing is *cheaper* comparing to internal one, but access to external resources depends on the credibility and country rating of Moldova on international markets. And both of them, as well as the slow pace of reforms during the last 2 years, led to a halt of financial assistance from international financial organizations. And their decisions are obviously signals to other potential investors into the Moldova's economy. It is clear, that investment and credit risks for Moldova have increased during the beginning of 1998.

2.1.2 Transitional budget in 1993-1998: a critical review

The transition from a plan to a market economy calls for almost a wholesome reinvention of government, as its role in production and distribution requires considerable transformation and reduction. This has been done to various degrees, and under different conditions in various economies undergoing transition. Although most governments' machinery has shrunk during the recent transitional reforms, it is not always proportionately reflected in the size of the government budget, as discussed below.

GDP and Government Consumption as % share of GDP; 1993-1997

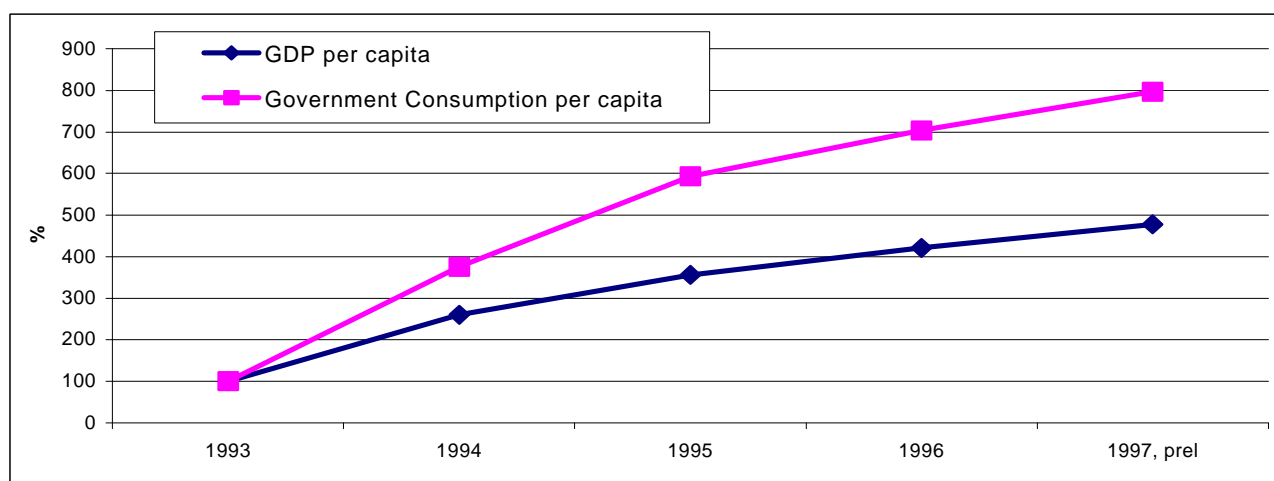
	1993	1994	1995	1996	1997, prel
GDP (lei million - current prices)	1821.0	4736.8	6479.7	7657.9	8655.0
Government Consumption (lei million - current prices)	282.7	1065.3	1678.4	1987.1	2242.0
Share of Government Consumption in GDP, %	15.5	22.5	25.9	25.9	25.9
GDP (lei million - constant prices 1993)	1821.0	1258.3	1234.4	1135.7	1150.4
GDP per capita (lei - current prices)	504.7	1312.5	1797.9	2127.2	2408.0

Source: Based on the data from the Department of Statistical and Sociological Analysis

As observed from table above, the share of the government expenditure has increased between 1993 and 1995, and remained unchanged until 1997. This is despite the fact that in real terms, the total GDP has actually declined by 36 % over the period concerned. Further, a comparison between the per capita income and the per capita government consumption reveals a much faster growth in the latter over the same period, at an increasing differential rate.

Graph below illustrates the widening gap between the income and government consumption per head.

Graph 1. Nominal Annual Percentage Change in GDP and Government Consumption (1993 = 100); 1993 –1997



Source: Based on the data from the Department of Statistical and Sociological Analysis

In Moldova the total government spending is made up of State budget, Local budgets and Social Security budget. The combined State Budget and the Local Budgets comprise the Consolidated Budget.

A schematic review of the public sector's share in the GDP in the last years is presented in the following table:

Consolidated Budget as % share of GDP; 1996-1998

	1993	1994	1995	1996	1997, ap.	1997, prel	1998, ap.
GDP (lei million, excl Trans.)	1821.1	4736.8	6479.7	7 317	9 100	8 655	10 100
Revenues (%)	20.4	30.4	31.4	28.35	28.8	34.0	29.2
Expenditures (%)	28.0	36.3	37.3	38.64	32.42	41.7	32.7
Budget Balance (%)	-7.5	-5.9	-5.9	-10	-3.6	-7.7	-3.50

Source: Ministry of Finance and Department of Statistical and Sociological Analysis

Here also it is noted that the share of total government expenditure has been on the increase compared to 1993, with a record high of 42% in 1997. However, the large gap between the government consumption and the government total expenditure poses a number of critical issues, including the pressure for subsidies, especially for energy and loss making enterprises, as well as bad debts and debt servicing.

Official data also show that the consolidated budget revenue share of the GDP increased each year from 1993 - 1995, with a slight fall in 1996. Figures for 1996 - 1998 indicate a rise in the revenue's share of the GDP in 1997, with an almost equally large fall in 1998 approved budget from 34 % to 29.2 %.

Finally, figures for budget deficit show a record high for 1996, and the actual deficit for 1997 to be double as anticipated in the 1997 approved budget.

The following table provides a general picture of the changes in the consolidated budget for 1996-1998 (excluding Transnistria).

Table 3. The composition of consolidated budget balance; current prices (lei million); 1996 - 1998

	1996	1997, ap.	1997, rect.	1997, prel	1998, ap.	01-04, 1998
State Budget Revenue	1249.2	1916.5	1875.0	2119.0	2289.9	494.0
State Budget Expenditure including transfers	1697.1	2246.5	2475.0	2726.1	2639.9	573.5
State Budget Balance	-447.9	-330.0	-600.0	-607.1	-350.0	-79.5
Local Budgets Revenue & transfers	1050.6	984.5		1255.7	948.2	287.4
Local Budgets Expenditure	1355.4	984.5		1403.7	948.2	303.2
Local Budgets Balance	-304.9			148.0		
Consolidated Budget Balance	-752.7	-330.0	-600.0	-666.8	-350.0	-93.2

Source: Based on data from Ministry of Finance

At first glance, it becomes evident that the state budget revenue grew at a remarkably high rate of 70% in 1997 as compared to 1996. The figures for the 1998 budget suggest that there will be an increase of 8 % for 1998, fairly higher than the earlier estimates of 5.2 %. The local budgets' revenue has been reduced by some 25 % for 1998, with almost half of it already accruing in the first quarter. Again, the reduction is larger than the 16 % as originally predicted. On the expenditure side, the approved state budget is also anticipated to have a growth of 17.5 % over the approved budget of 1997. The figures for the first four months of 1998 show a less than proportionate deficit of 93.2 million lei, compared to the anticipated annual figure of 350 million lei.

Budget revenues in Moldova, in line with the international standards, comprise taxes, non-tax revenues and capital operations revenues.

The table below gives a picture of the structure by source, and its changes over 1996-1998.

Table 4. Structure of consolidated budget by source of revenue as % share; 1996-1998

	1996	1997, ap.	1997, prel	1998, ap. 1-03, 1998	
Revenues, total (million lei)	2074.16	2620.60	2942.40	2950.00	518.39
	% share in revenues				
1. Tax revenues	79.84	82.81	78.11	79.32	
Direct taxes	34.19	28.62	23.13	23.39	21.72
- profit tax	17.29	14.50	8.30	11.19	8.76
- income tax from indiv.	10.56	8.78	9.55	5.42	10.36
- land tax	5.58	4.39	4.26	5.08	1.81
- on real estate	0.75	0.95	1.02	1.69	0.79
Indirect taxes	43.64	52.47	50.24	55.93	45.38
- excise taxes	9.47	16.79	13.65	20.34	14.08
- VAT	29.60	30.53	32.26	30.51	25.35
- taxes for external operations	4.57	5.15	4.33	5.08	5.95
2. Non-tax revenues	20.16	17.19	13.62	19.08	
- revenues from property and entrepreneurship activity			10.19	6.78	
- other non-tax revenues	18.35	14.12	3.44	12.31	
3. Capital operations revenues	1.82	3.08	8.24	1.59	
Total	100.00	100.00	100.00	100.00	

Source: Based on data from Ministry of Finance

Revenues from direct taxes have been steadily decreasing their share from 34.2 % in 1996 to a predicted low of 23.4 % for 1998. In this category, only real estate tax shows slight increase (due to revaluation of fixed assets of economic agents and real persons), with the rest falling, especially income tax from individuals. This confirms the difficulties in identifying the income sources of individuals, as well as the discouraging impact of tax rates on the declaration of profits. By contrast, the relative share of indirect taxes in the revenue has been on the increase, especially with regards to excise taxes. The growth of tax revenue for 1997 is explained both by the increase in the taxable commercialized volume of products by 15-20 %, and by the increase in the average value added tax on the volume of sold products compared to the level of 1996. These are mainly linked to the recent structural changes in the manufacturing, raw material and consumer goods sectors. According to the 1997 State Budget Law, there were some concessions on VAT to certain types of producers amounting to lei 301.5m during 1997. This included tax benefits for bread production and sale (lei 73.1m), for milk and dairy products (lei 20.3m), for plant and animal production (lei 155.6m), for public utilities (lei 26.6m) and for natural and liquid gas (lei 9.3m).

The double increase of excise taxes was caused by increasing the rates on some domestic products (cognac, non fermented tobacco), undertaking some concrete measures over controlling the excise collection by State Tax Service, Department of Financial Control and Inspection as well as by customs authorities, and licensing the imports of gas and diesel.

In the non-tax category, incomes from privatization are likely to increase their share more than threefold. This is not surprising given the present phase of accelerated privatization.

However, as this should be only considered as a transitory source of revenue, a more far-sighted view of the future budgets should consider alternative sources in its place. On the same note, it is important to emphasize that the primary objective of privatization ought not to be raising revenue for meeting the budget expenditures, as is believed to have been the case in a number of CIS countries, including Moldova.

According to the information from the Ministry of Finance, in the first quarter of 1998 the collected revenues in the consolidated budget stood at lei 518.4m or 17.6 % of the annual planned figures. The state budget revenues constituted lei 394.3m; at a similar proportion of 17.2 % of the annual planned figures. The figures for the local budgets are lei 221.9m at 23.4 % of the annual planned figures. The first three months of the 1998 have observed a positive tendency in the collection of the income tax from individuals. The amount collected stood at lei 53.7m, which is about 33 % of the annual planned figures. The amount collected from the VAT, excise taxes, and profit tax stood at around 11-14 % of the annual planned figures. Moldova still has many unprofitable enterprises, where in a vast number of branches they are making considerable losses. This is likely to worsen further especially owing to the increase of the energy and other imported inputs share in the cost of production. This problem may largely explain some of the difficulties in collecting taxes.

Because of the seasonal character of activities of the main sectors, there is a tendency for the revenues to accrue more during the second half of the year. By way of example, in 1996 and 1997 respectively 32.0 % and 42.5% of the total revenues were collected only in the last quarter of the year.

Looking at the structure of expenditures as provided in the following table, we observe that the largest items of expenditure have been education and health throughout the period concerned, although at a falling rate. Comparing the figures for approved 1997 and preliminary (actual) figures, it is noticeable that the share of government expenditure on health care was smaller than predicted. Health care and education are both essential development concerns, and so far they have been rightfully held at the top of the government priorities in Moldova. The third largest item though is the public debt service, rising at an alarming rate from 8.6 % to 14.2% over the period. This is a rate of growth of 65 % over the period and of 30 % in 1998 over 1997. Capital investment, by contrast, has remained at a stagnant, low proportion of the public expenses.

Table 5. Structure of expenditure in the consolidated budget by % share; 1996-1998

	1996	1997, ap.	1997	1998, ap	01-03,1998
Expenditures, total (million lei)	2827.0	2950.6	3609.2	3300.0	546.0
% share in expenditures					
General State Services	3.85	2.99	3.85	2.58	4.93
Foreign Activity	1.03	1.50	1.03	1.06	0.47
National Defence	2.50	2.36	2.50	1.82	2.37
Juridical Authorities	0.73	0.87	0.73	0.62	0.86
Public Order & National Security	6.30	6.96	6.30	6.10	6.28
Education	28.42	24.19	28.42	21.79	23.80
Scientific Research	1.06	1.40	1.06	0.91	0.98
Culture, Arts, Religion, Sports	2.19	2.31	2.19	2.35	2.11
Health Care	18.46	17.39	18.46	15.31	16.22
Social Security and Support	5.91	14.21	5.91	16.69	17.81
Agriculture, Forestry, Fishery	3.74	2.52	3.74	20.06	1.69
Environment Protection	0.23	0.29	0.23	0.25	0.23
Industry and Constructions	0.11	0.59	0.11	0.08	0.07
Transport, Road Administration, Communication & Informatics	2.88	4.31	2.88	3.74	3.27
Public Utilities Administration & Use of Housing Stock	2.52	1.58	2.52	1.06	1.35
Complex for Fuel & Energy	0.04	0.01	0.04	0.01	0.01
Public Debt Service	8.60	12.84	8.6	13.64	13.21
internal		6.40			
external		6.44			
Completing State Reserves	0.32	0.29	0.3	0.28	0.09
Other Services Related to the Economic Activity	0.39	0.27	0.4	2.71	0.17
Other Expenditures, not included in main groups	5.05	2.23	5.0	0.78	19.98
Capital Investments	5.49	4.41	5.5	5.45	2.13
Total expenditure	100	100	100	100	100

Source: Based on data from Ministry of Finance

On the expenditure side there is a need to restructure the major items of expenditure, especially education and health, where capital and administrative structures are not necessarily appropriate for modern conditions. However, effective restructuring takes time to plan and then to implement. In Moldova, as elsewhere in the CIS countries such programs are mainly at the planning stage. Until implementation is possible, the squeeze on expenditures will affect standards in these critically important areas of human and social capital.

In the first quarter of 1998 the consolidated budget expenditure constituted lei 546.04m or 16.5 % of the planned annual figures. The share of the state budget expenditure was 79.4 % of the total consolidated budget expenditure, and 16.4% of the annual figures. The priorities receiving state financing were the education sector with lei 129.9m, or 23.8% of the total expenditure, social security and support with lei 97.3m or 17.8 %, health care with lei 88.5m or 16.2% and the public debt service with lei 72.1m lei or 13.2 % of the total state budget expenditure in the first quarter of 1998.

On the 1st January 1998, Moldova's external debt reached \$ 1 192 million, an alarming 64 % of the GDP. This is a critical level for any economy with serious limitations on export earnings and creditworthiness, such as Moldova. Equally critical is the fact that all the external finance is directed to the external debt service. In 1997 the external debt service was about \$150 million, that is over 20 % of the total consolidated budget revenues. At the same time the new external loans for 1997 were in fact less than the debt service paid in the year by \$20 million, standing at \$130 million. Should the current trend continue over the next few years, it might surpass being critical, as it will become impossible to sustain. In 1998 Moldova will have to spend \$215 million for the external debt service. This will make it difficult for Moldova to borrow externally by issuing new Eurobonds.

Financing of the budget deficit

The figures for the end of 1997 show that the budget deficit stood at 7.7 % of the GDP or 2.1 points less than in 1996. The preliminary figures for the first quarter of 1998 show that the budget deficit stood at lei 27.7m. The deficit was covered both by internal and external borrowing. Notably, 91% of the total deficit of the consolidated budget belongs to the State Budget.

Internal financing is carried out by raising loans from The National Bank of Moldova and commercial banks, and issuing state securities. The loans from the NBM represent 52 % of the internal state debt while those from commercial banks constitute a much smaller share of 1.3 %.

During 1997 some lei 1190.8m worth of State Securities were sold; showing an increase of 68 % percent as compared to 1996. Most profitable are the 91-day securities, the reasons being higher profitability and a more attractive maturity period compared with other securities. The highest interest rate here is a reflection of the adjustments to perceived risk attached to an emerging economy's debt following the problems in Asian markets. This can be explained by the abolition of taxes on State Securities operations. In 1997 the Ministry of Finance allocated lei 168.8m from the sale of governmental securities to covering of the state budget deficit.

According to the Law on the State Budget 1998, the tax on operations with State Securities on the secondary market and the tax on revenue received from operations with State Securities are abolished until 1999. This may considerably extend activities on the State Securities market, especially on the secondary one. Using this financial instrument, economic agents can more effectively use available resources. It should be emphasized that the tax on operations with State Securities on the secondary market mostly affected operations with securities having a 28 -day maturity period. The relatively small volume of transactions in these securities confirms this.

The extent of the T-bills market creates certain difficulties in other potential investment activities. The high interest rates required to finance the budget deficit diverts the flow of funds from real investment projects, where the interest rates are lower. The recent announcement on the 19th of May by the Ministry of Finance regarding the reduction of the nominal price of the T-bills from 1000 lei to only 100 lei will be another step in that direction. The recent changes aim at attracting the household resources to the T-bills market.

As of January 1st 1998, the external state debt, administrated by the Government, equaled \$709.1m (lei 3304m). The limit approved for the external state debt in 1997 the State Budget was set at \$780m. The growth of the external debt of the state as compared to January 1st 1997 was about \$60m or 9.3 %.

The biggest share in the structure of the external state debt is related to the loans received from the commercial creditors, including Gazprom with \$ 306.6 million, followed by multilateral loans extended by international financial bodies (World Bank, European Bank for Reconstruction and Development etc.) with \$ 255.5 million, and the loans extended by the Governments of other countries with \$ 147 million.

During 1997, new credits worth \$135.4 million were received. This included issuing of Eurobonds totaling \$ 75 million , the first portion of the loan granted by the World Bank for structural adjustments under SAL-2 worth \$ 35 million, investment credits by the World Bank and The European Bank for Reconstruction and Development of \$ 8.6 million.

Following the objectives of creating an active financial market in the past three years, including a market in three-month government securities and Treasury Bill single-price auctions, the Ministry of Finance has issued a new type of Treasury Bills with a 14-day maturity. In

November 1997 there was a new programme launched, aiming at introducing bonds with a two-year maturity. Moreover, the Ministry of Economy and Reforms and the National Bank of Moldova plan to jointly examine the possibility of elaborating on a programme of medium-term Eurobonds for Moldova, which will give permanent access to external markets. However, this plan has witnessed a set back in November, when the Asian financial markets faced extensive turmoil. The concern has been that the risk might prove too high for Moldova to be exposed to external markets in the face of serious uncertainties. The Ministry of Finance has postponed negotiations on the possible issue of Eurobonds until the second half of 1998. Issuing in the first half of the year, it will possibly increase the expenses by 20 %. The Ministry of Finance affirms that Moldova is not satisfied with the actual interest rate on Eurobonds, which stands at 14-15 % per annum, and is considered too high. In the opinion of the Ministry of Finance the interest rate on Moldovan bonds should not exceed 10-11 % per annum. However, the possibilities for Moldova to issue the Eurobonds are very limited. This situation is caused mainly by two factors, first Moldova has already issued \$ 75 million of Eurobonds, and second, the debts to Gazprom far from showing any signs of diminishing, have been accumulating further.

The primary goal of budget and fiscal policy for 1997 had been directed towards the maximum mobilization of public and private sector revenues to create favorable conditions for good governance objectives. These included in particular the implementation of a set of measures designed to minimize the possible tensions in society by supporting the current payments and reducing the arrears on pensions and salaries. In effect however, the priority budget actions during 1997 turned out to be the financing of most stringent budget expenses, especially the integral payment of the previous years debts and obligations.

In a broader context, and learning some lessons from 1997, the major areas of concern to be taken into account for rectifying and implementing the 1998 budget can be identified as the following:

Developing the capacity within the relevant institutions for a realistic forecast. This should not be solely confined to forecasting the budget, but rather for the whole economy. As stated earlier, the construction of a viable budget is closely dependent upon the ability of a given economy to generate sufficient revenue sources. In Moldova, as elsewhere, arriving at a balanced economy without undue, extensive cuts in the public sector's obligations towards development can only be possible, if and when, the whole economy improves in line with the set objectives. At the moment, the poor forecasting capacity, combined with political considerations, no matter how justified, result in unrealistic estimates of both revenues and expenditures. So far, it has created additional obstacles in obtaining the goals, as repeated rounds of revisions and negotiations have become a permanent feature.

Related to the above point, is the necessity to formulate the budget and its implementation in the context of priorities and possibilities. In other words, the usual main focus on meeting the financial requirements of the activities, which are already in place, should make room for a more strategic vision.

Last but not least, the growing concern about the shadow economy needs to be reflected in the outlining of an envisioned transformation of the economy, in more practical and focused way, than the mere expression of concern. Within the existing or emerging new institutions, there is ample capacity, know how and willingness to tackle this issue from different angles. It would be timely to mobilize and encourage systematic work on this issue to provide the necessary information and analysis into the cause and possible remedies. The ambiguity of a growing part of the economy can in no way be dismissed any longer, specially when arriving at realistic figures for policy making is concerned. One such immediate area is, evidently, the formulation and implementation of realistic budget for 1998 and beyond.

2.2 Monetary policy, country's external position, and banking system

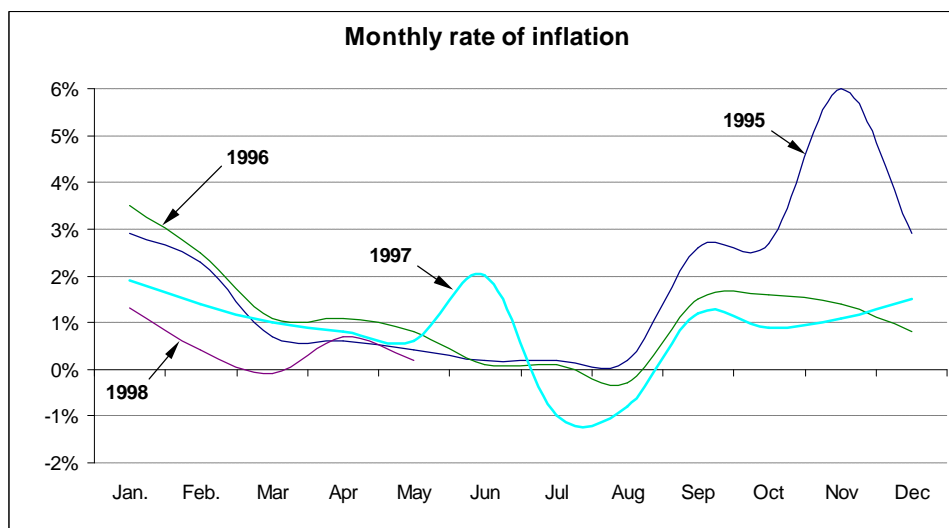
Monetary policy and its objectives are outlined, elaborated and implemented by the National Bank of Moldova. Its main directions of activity include: issuance and control over cash circulation, foreign exchange reserves management, compilation of state's Balance of Payments, auctioning of securities issued by the Ministry of Finance, observing banks' reserves and banks' credit servicing, supervision of commercial banks' activity and ensuring their safety.

The prime target of monetary policy is maintaining the stability of Moldovan leu – both external stability - vs. main hard currencies, and internal - stability of domestic prices and inflation rate. At present the main instruments of monetary policy are: open market operations, mandatory reserves requirement, buying-selling of foreign exchange.

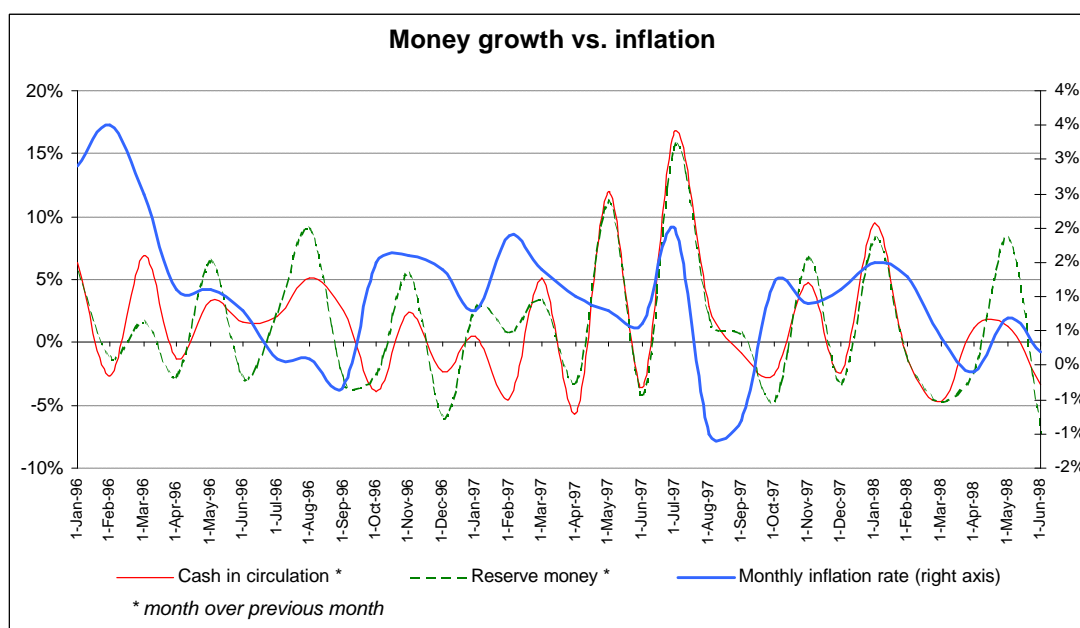
Monetary policy: main indicators

During 1998, in spite of external and internal constraints, the monetary policy continued to be oriented towards reducing of the inflation rate and maintenance of the exchange rate of national currency.

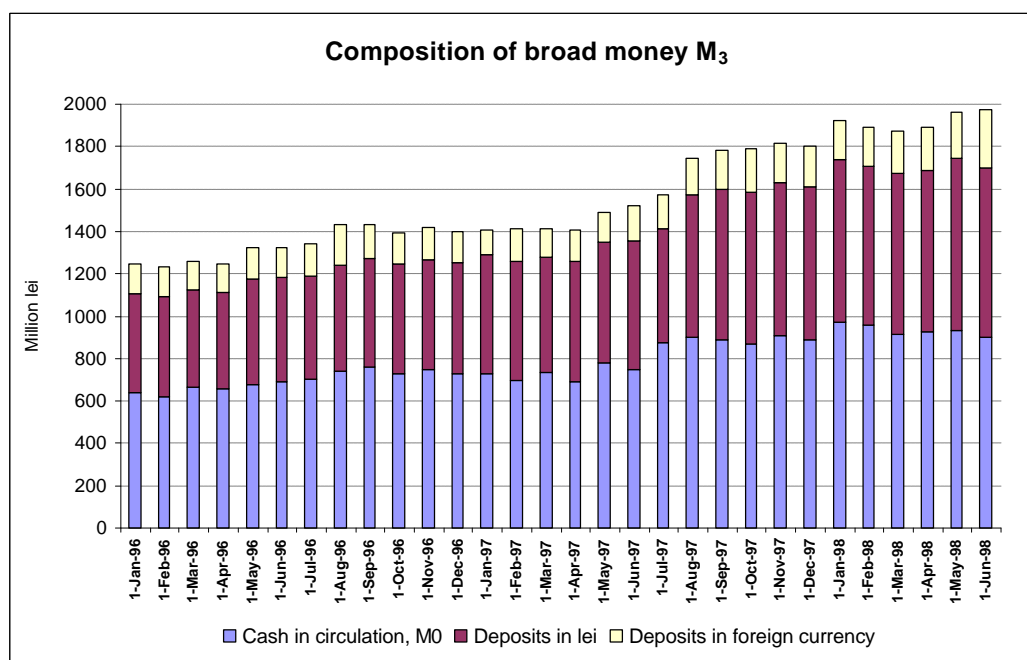
In 1998 inflation rate showed a significant shrink comparing to previous years. In March a deflation of 0.1% was observed. For the period January-May 1998 rate of inflation totaled 2.5% if compared to the level in December 1997, and the increase of prices in May 1998 over the same period of last year was 7.6%. This evolution shows that the annual inflation rate for 1998 could stand at 7.6-8.5%, comparing to the 11.2% registered at the end of 1997. Price seasonality shows the same tendencies as in previous years.



In the first quarter of 1998 the main monetary indicators showed a downward trend (which is in fact common for the last 3 years), resulting from the implementation of a non-expansionary monetary policy. Cash in circulation has curtailed by 4.9% at the end of first quarter 1998, if compared with the beginning of the year. During the same period base money has reduced with 7.4% (in the first quarter of 1997 cash shrank by 5.2% and base money – by 0.5%). By the end of May 1998 the volume of lei in circulation fell, comparing to the beginning of the year, by about lei 70m, i.e. by 7%, as a result of NBM's interventions in the foreign exchange market.

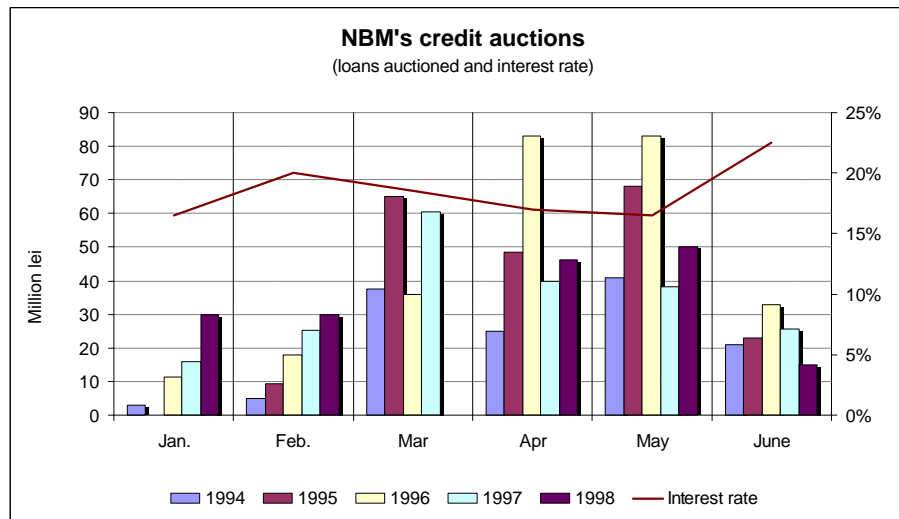


Broad money M_3 has shrunk during the first quarter of 1998 by 2.65%, while the level of deposits remained steady. Already in April 1998 broad money has increased by 3.6%, and deposits with banks – by 6.1%. And as of 1 June 1998 the growth of broad money was 2.6% over the beginning of the year, while deposits with banks grew 12.5%. Therefore, a positive evolution during the reported period of 1998 represents the continuous increase of the share of deposits in monetary aggregate M_3 : from 49.4% at the end of last year, to 54.2% as at 1 June 1998.

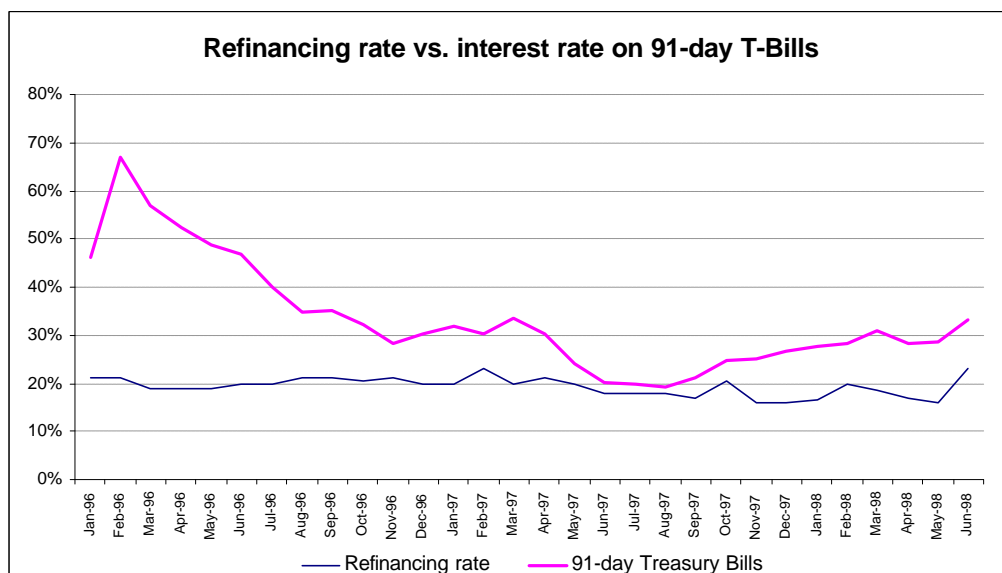


Monetary policy: main instruments

During the first half of 1998 were held 9 refinancing auctions at which there were sold lei 171m of credit resources, comparing to the lei 205m auctioned at the same period of last year, or lei 265m sold in January-June 1996.

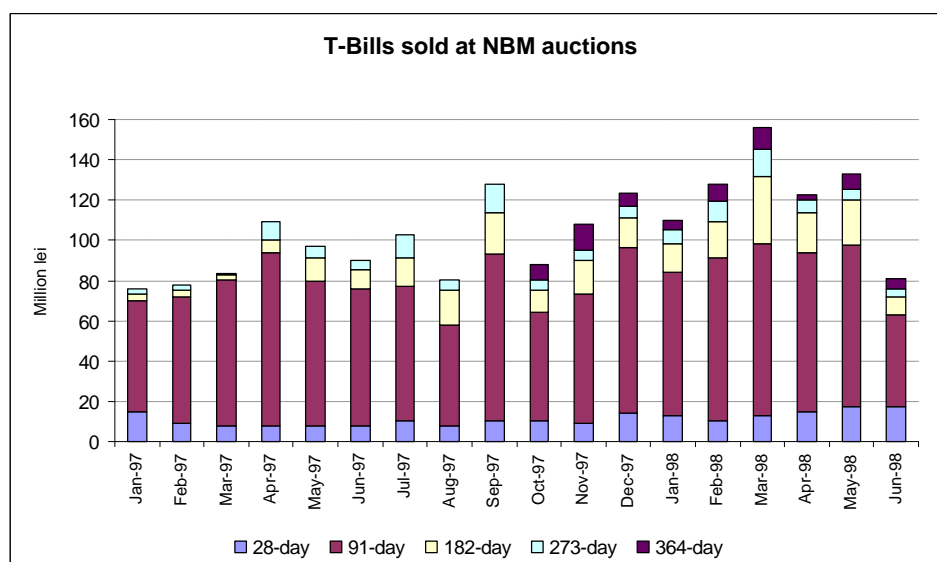


NBM's annual refinancing rate has declined slowly to 16% in May 1998, however at the auction held on June 15 it jumped to 22.5%. This was a normal response under the circumstance of continuous increases of interest rates on T-bills. In the chart below this evolution is clearly shown, being compared the refinancing rate with the interest rate on 91-day T-bills, which have the biggest transaction volume.



It should be mentioned, that this was the last refinancing auction, because afterwards they will be totally replaced by open market operations – Repo agreements and Lombard facilities. Consequently, large discrepancy between the refinancing rate and T-bills interest rates will be cleared. This discrepancy allowed banks to buy cheap credit resources and use them for financing state budget deficit, thus getting easy and guaranteed profits.

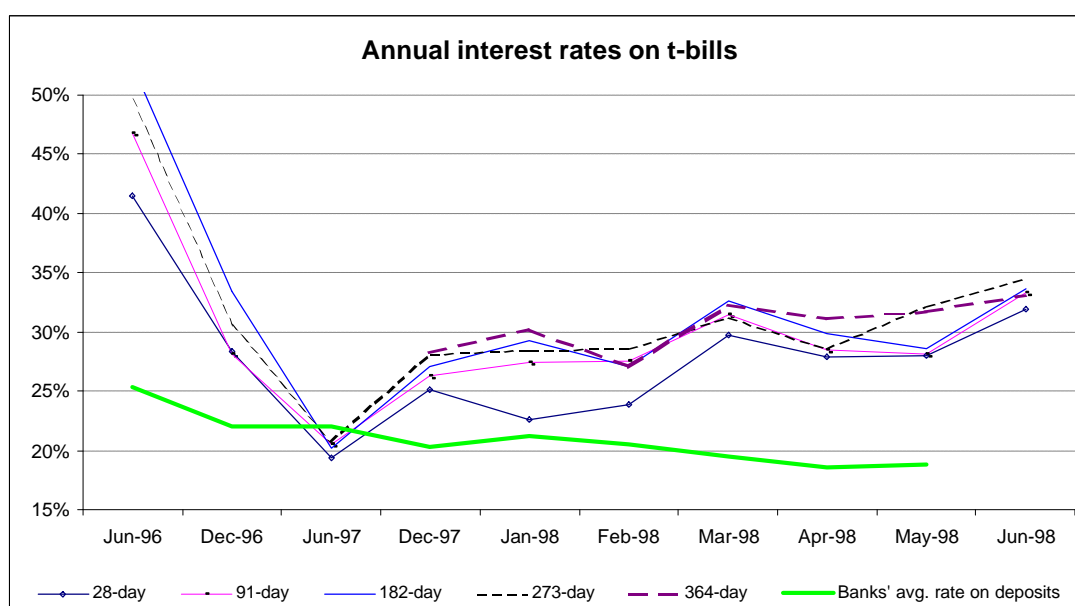
As the state's agent in selling state securities, during January-June 1998 National Bank of Moldova has sold to commercial banks at auctions T-bills amounting to lei 732m. Their structure was the following: 91-day – 60%, 182-day – 16%, 28-day – 12%, and about 12% – longer term securities. A positive aspect here is the continuous increase in the relatively long term securities: in January 1997 the share of 28-day and 91-day T-bills out the total sold was 92%, in June 1997 it was 84%, and in June 1998 – 72%.



During the reported period of 1998 interest rates on Treasury Bills and Bonds have been continuously growing. This is explained by state's acute lack of financial resources. Having a dangerous budget deficit and lack of funds for covering it, the only solution applicable by the Government in order to attract financial resources is issuance of securities, which gets bigger proportions with the time.

Under these circumstances, for making them attractive, the state is continuously increasing the interest rates on state securities, at the same time more funds are needed for servicing securities already issued. Already now the income from the new issuance of state securities can not even cover the amount needed for repurchasing the previously launched securities.

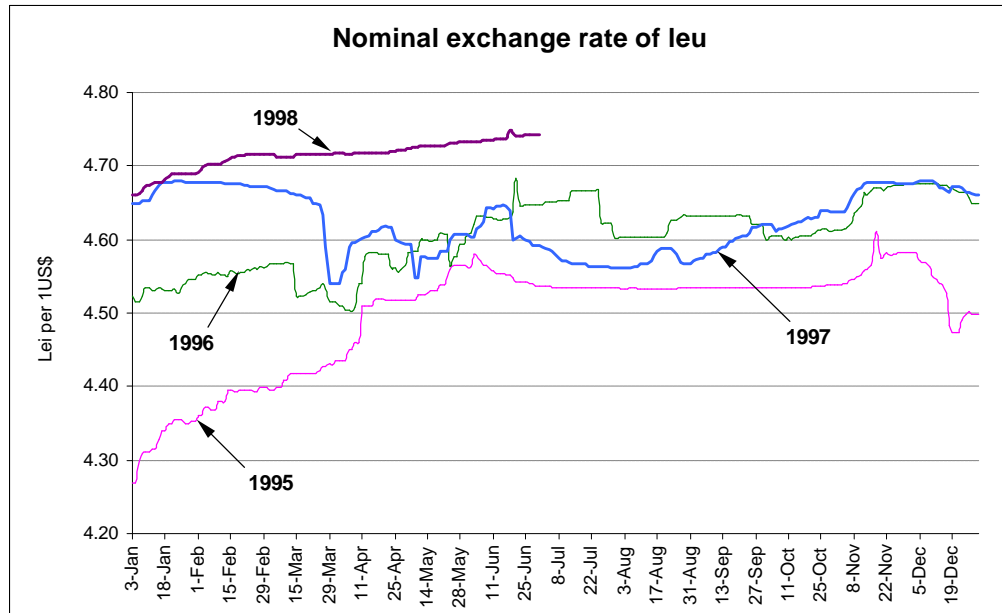
It must be stressed here, that during the second half of 1996 interest rates on T-bills were considerably higher than deposit rates in the banking system, consequently banks being massively involved in buying state securities instead of channeling crediting resources into the productive sector. Thus, the deposits of banks' clients were used for covering budget deficit. Due to the reduction of the interest rates on T-bills, this situation improved towards the end-1997, which is clearly shown in the chart below. However, already by the end of 1997 and during this year the interest rates on bank deposits, which have been gradually decreasing along with the central bank's refinancing rate, dropped far below the interest rates on state securities, which show a continuous upward trend.



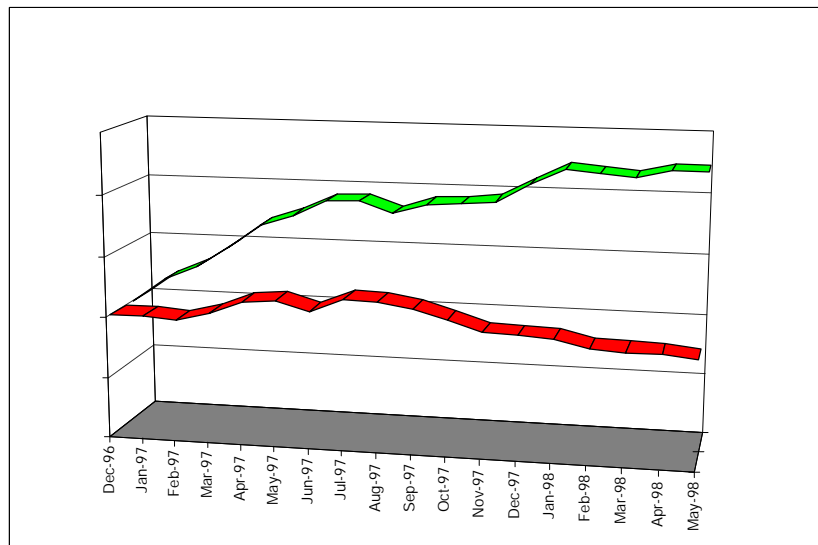
Exchange rate dynamics

During 1998 the exchange rate of the national currency against US dollar follows a more stable path comparing with previous years, undergoing a slow nominal depreciation – by 1.2% in May 1998 upon December 1997 (average monthly rate).

Current month May over December last	m'94/d'93	M'95/d'94	m'96/d'95	m'97/d'96	m'98/d'97
Nominal appreciation (+), depreciation (-)	-8.6%	-5.9%	-1.4%	+1.8%	-1.2%
Real appreciation (+), depreciation (-)	+56.7%	+0.7%	+7.8%	+7.8%	+1.3%



Due to the reduction in inflation rate, also has lowered the real appreciation of the national currency against US dollar (which was too high in previous years). In May 1998 real exchange rate index shows an appreciation of Moldovan leu against dollar: by 20.9% comparing to December 1995, by 12.4% comparing to December 1996, and by 1.3% comparing to December 1997.

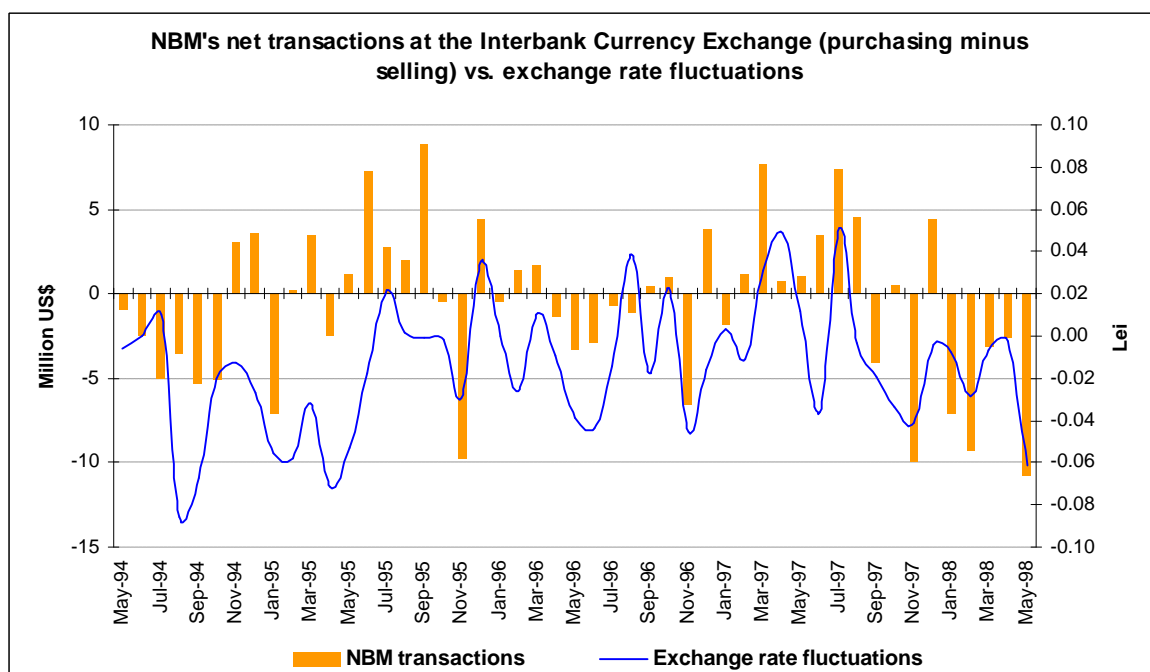


As regards to the real effective rate of Moldovan leu against currencies of the main trading partners of Moldova (Russia, Romania, Ukraine, Belarus, Germany, Italy), and adjusted to the inflation in these countries, the following is to be noted: according to CISR calculations

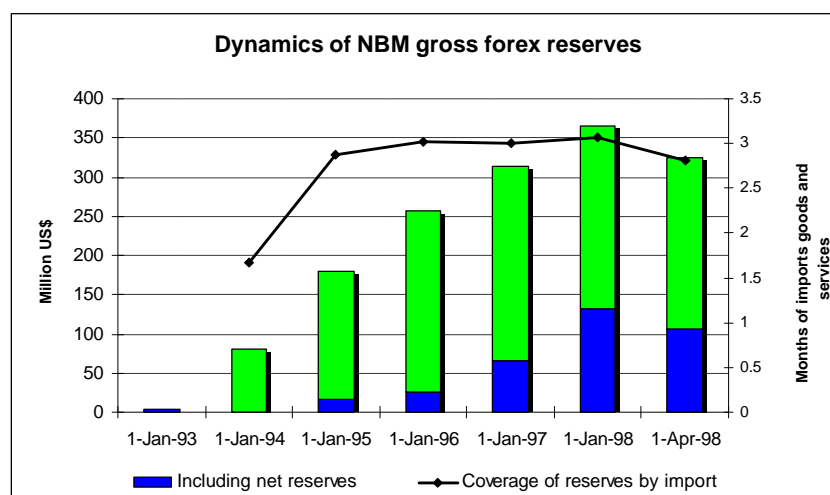
in 1997 over 1996 the Moldovan leu has appreciated by 12.4% upon currencies of the main trading partners of Moldova, which to a certain extent affected the performance of Moldovan exports.

Evolution of NBM foreign exchange reserves

An alarming trend represent the massive sales of hard currency of the NBM at the Moldovan Interbank Foreign Currency Exchange in 1998. In previous years NBM's transactions at the Interbank Foreign Currency Exchange had a stable seasonality evolution, while during the period January-May 1998 the NBM bought zero foreign exchange, and at the same time sold considerable amounts of hard currency – almost \$33m.



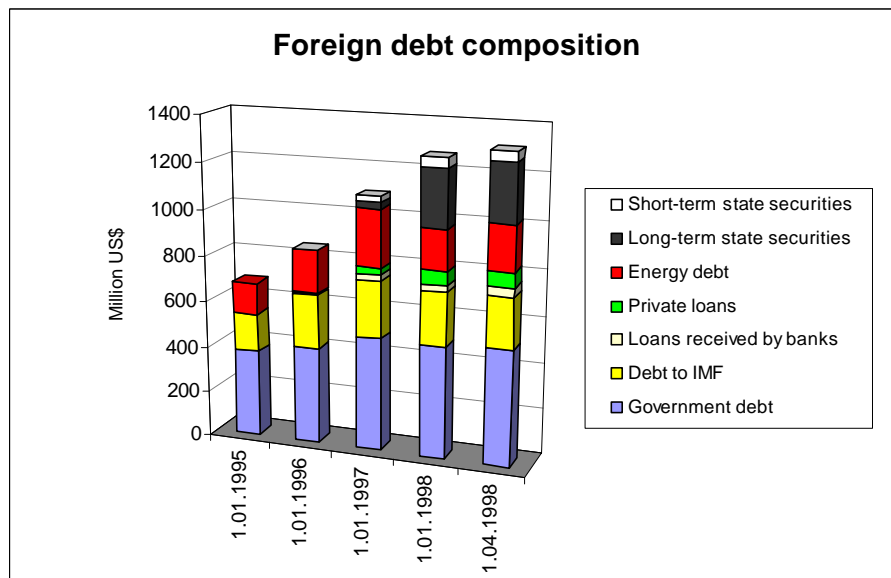
This obviously led to a reduction of NBM's foreign exchange reserves. During the same period of time gross reserves decreased by 9% (covering at the end of first quarter of 1998 2.8 months of imports), and net reserves – by a quarter. This reduction of NBM's reserves is accompanied by a slow devaluation of the national currency. For the moment the situation is under control, but it should be mentioned that if the demand for hard currency in the market will not decrease, then it could have a serious impact on the exchange rate, in the end causing a bigger devaluation of the Moldovan leu.



Another critical aspect within the context of the official forex reserves reduction is linked with the need to service external debt, which implies transfer of big amounts in hard currency for the repayment of principal and interest. Here is a simple calculation: during the 1st quarter of 1998 gross forex reserves reduced by \$41m, while at the Interbank Foreign Currency Exchange there were sold \$20m. Therefore, the difference was used for external debt servicing. For the following period of time the situation will aggravate even more, because already in 1998 the state has to repay more than \$200m for foreign debt servicing (including almost \$80m to be paid by NBM only, for the principal and interest to the IMF). And all this is happening under an aggravating factor such as the considerable current account deficit of the balance of payments.

Foreign debt of Moldova

The numbers regarding Moldova's foreign debt used here include the following: medium and long term loans received by the Government, IMF loans granted to NBM, state securities, loans received by commercial banks and private sector (including government guarantees), as well as debt for energy resources.



The stock of foreign debt at the end of the 1st quarter of 1998 has reached, according to BOP data, \$1306m, which is 3.0% more than as at 1 January 1998 and 19.7% more than as at 1 January 1997. In fact, the significant growth of debt during 1997 is largely owed to the second private placement of Eurobonds through Merrill Lynch in the amount of \$75m, as well as to the equivalent of \$140m of state securities issued by the Ministry of Finance for covering the energy debt to Russia's Gazprom. As regards to the loans from international financial institutions, they were substantially reduced because Moldova did not follow the concluded memorandums. Consequently, in 1997 Moldova received only one tranche of \$20m from the IMF within EFF, and a tranche of \$35m out of SAL-2 from the World Bank.

In this circumstances prospects for 1998 seem to be quite modest. IMF June 1998 mission made reference to an eventual next tranche of \$20m from the EFF loan, which could be granted in autumn 1998, only if Moldova will follow the obligations stipulated by the signed memorandum. World Bank June 1998 mission also promised relaunching of financial support by autumn, but it is clear that the next tranche of \$35m from SAL-2 would not be granted before the IMF tranche. And of course, the main condition here is also the execution of the agreement concluded between the Government of Moldova and World Bank.

At the same time, during 1997 Moldova had to repay about \$160m for its foreign debt servicing. It must be noted, that for the first time the outflows for debt servicing almost

balanced the inflows of currency out of new borrowing from international financial institutions and private capital markets abroad. This is a very worrying sign, especially because at the end of 1997 the current account deficit of BOP reached about \$300m.

During 1998-1999 the situation could be even more aggravated, because the external financing deficit, or deficit of hard currency inflows, will be even higher. It also obvious, that Moldova does not have enough gold or hard currency reserves in order to resist a crisis, in the event it happens. Only short term country's obligations reflected in the BOP External Position are already exceeding NBM's gross forex reserves (out of which two thirds belong to IMF).

The only chance, here, to find a way out of the impasse and for avoiding a major crisis of country's payment capacity is obtaining new favorable loans from international financial institutions. There are no other sources of foreign currency.

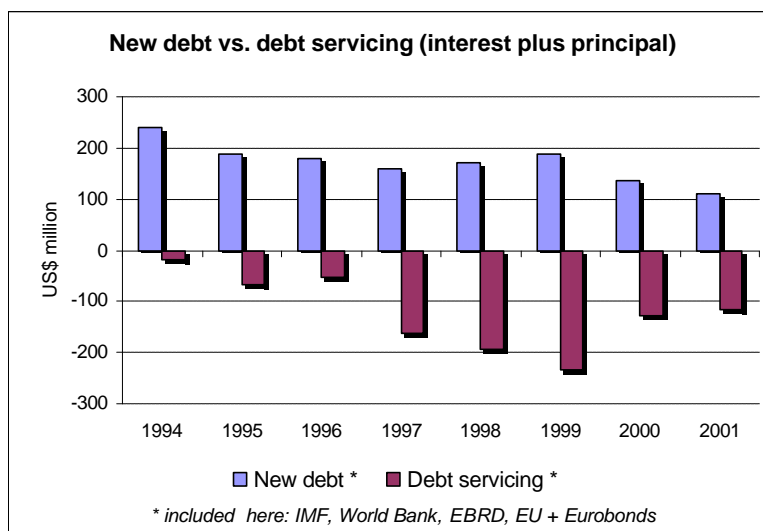
Moreover, the country's credit rating issued by Moody's and IBCA will be revised, and the new rating will certainly not be Ba2, but probably B1, i.e. 2 steps lower (or in the best case Ba3). This will limit considerably country's capacity to place new securities in the capital markets abroad, because as a result of altering of the country's image in the world the cost of servicing new Eurobonds will considerably increase.

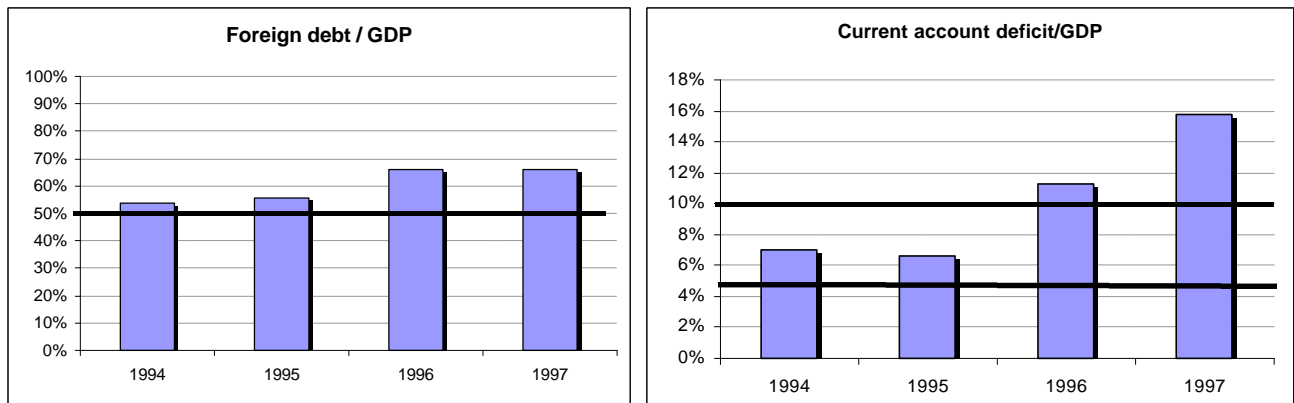
Thus, it is extremely important to continue the collaboration between Moldova and international financial institutions, especially IMF and World Bank, which are also our main creditors. However, the country could count on relaunching of the blocked tranches of EFF and SAL-2 only in case it fulfills the engagements regarding efficient implementation of structural reforms in the economy.

External position of the country: main indicators

According to BOP data external debt of the country (including debt to IMF) reached at 1.01.1998 about 66% of GDP.

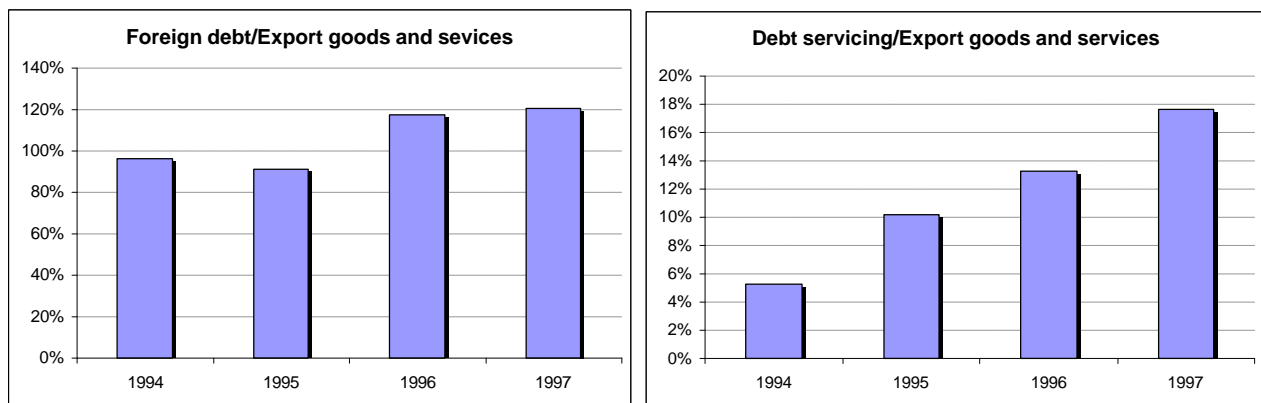
According to the World Bank methodology of calculating the indicators of country's indebtedness, the Republic of Moldova belongs to the category of countries with moderate level of foreign debt, the ceiling here being 80% of GDP. But it should be noted, that in case of Moldova the level of external debt of already 50% of GDP is quite dangerous, because of the considerable BOP current account deficit.





At the end of 1997 current account deficit reached \$296m, which accounts for 15.8% of GDP. This is a very alarming tendency, because in terms stipulated by economic theory exceeding 4.5% must be a worrying sign, imposing the Government and Central Bank the objective to correct the disequilibrium in a short term period. However, exceeding the 10% mark must be considered as critical, proving the existence of serious malfunctions in the economy, when just fiscal or monetary measures are no longer sufficient. They must be accompanied by vigorous sectoral policies, which could correct the disequilibrium only after at least 2-3 years of rigid implementation.

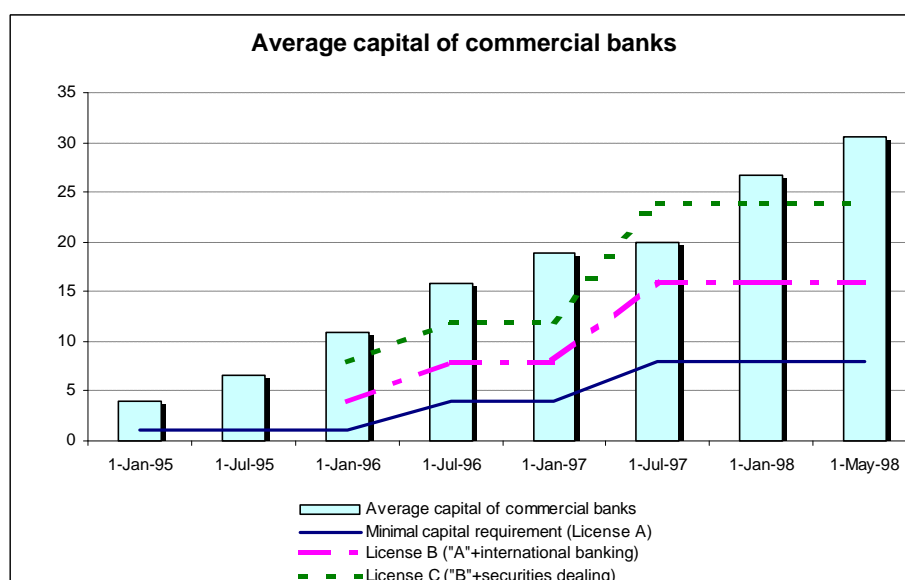
Other indicators:



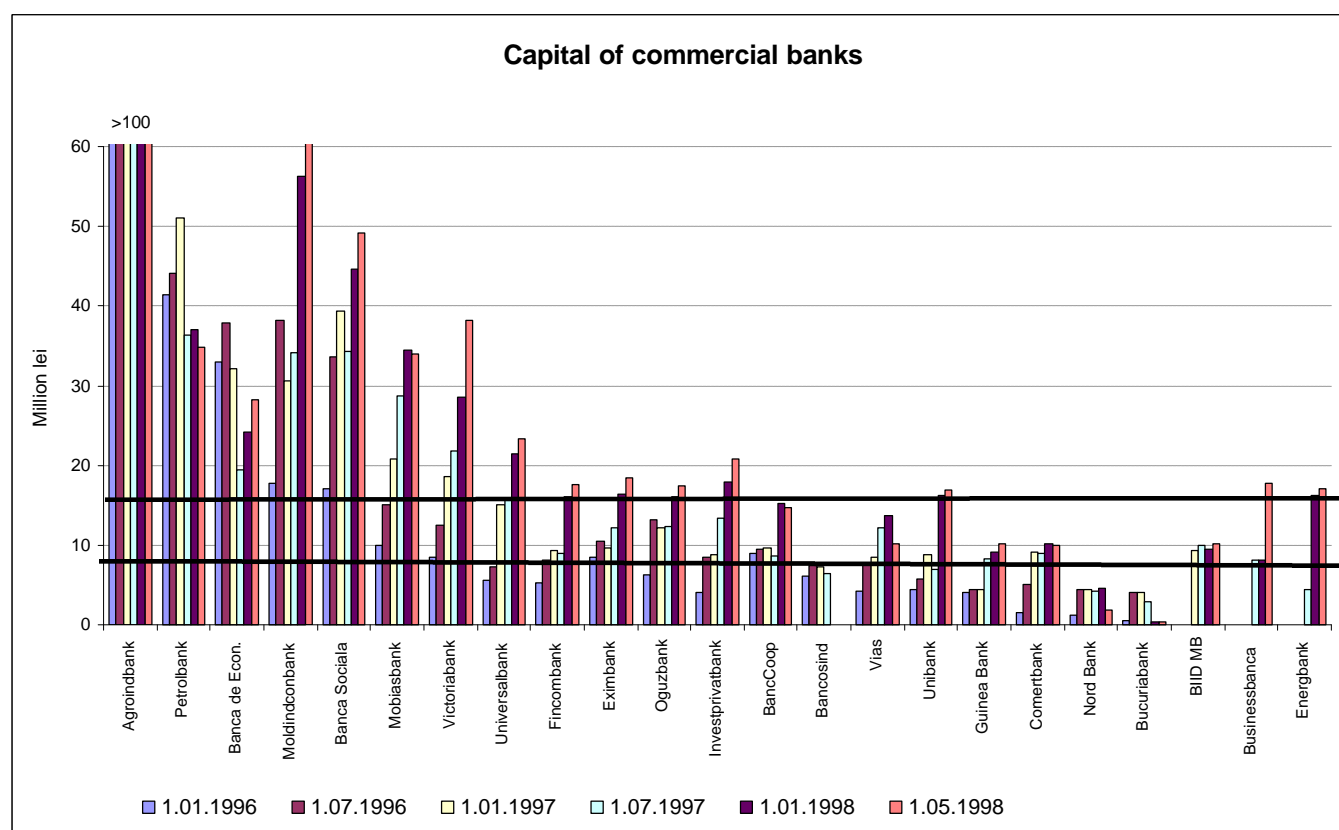
Evolutions in the banking system

The situation in the banking system of Moldova (22 commercial banks) can be generally assessed as positive. NBM continues to implement successfully prudential norms aligned to the Basle standards of banking supervision. Starting 1 January 1998 has been enacted a new minimal capital requirement for commercial banks – 8 million lei for receiving a type A license (basic license); also, the capital adequacy ratio (total regulatory capital/risk-weighted assets) was increased from 6 to 8 percent. Due to the fact, that in 1997 three out of four banks were performing international operations in foreign currency (types B and C licenses), they had to increase their total capital to the extent that it was needed according to the new requirements – i.e. to be bigger than 16 million lei. Therefore, the total capital in the banking system grew gradually, reaching at 1 January 1998 lei 588m, which is 35% more than at the beginning of last year. The same trend continued this year, total banks' capital reaching lei 643m at 1 May 1998, which is a 9.4% growth over the beginning of year.

For the reason of simplicity, on the chart below the evolution of average capital in the banking system is shown, calculated as a ratio between total capital in the system and number of commercial banks.



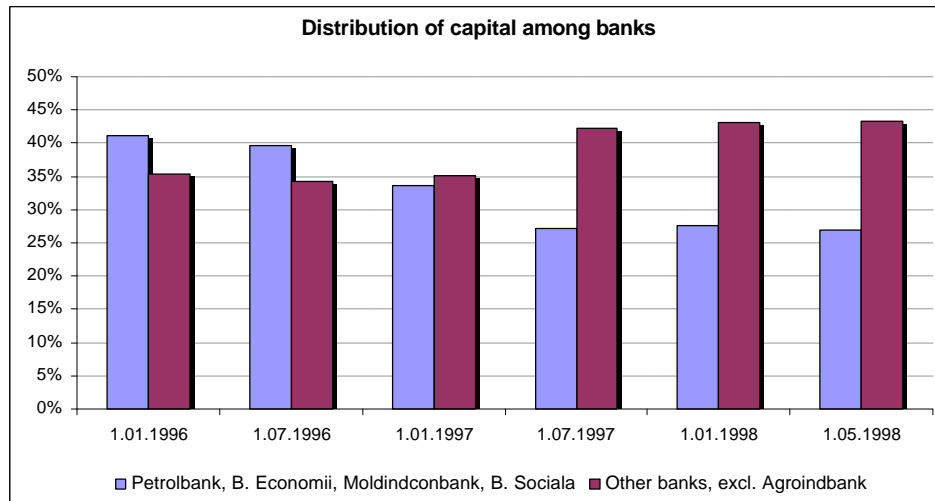
Additionally, a more exact evolution of the banks' capital and its distribution among banks is shown in the following chart. One could clearly notice the considerable jump of the banks' total capital starting 1 January 1998 due to the introduction of the minimal capital requirement of 8 million lei (the horizontal thick line at the bottom) and of the 16 million lei requirement for performing international banking operations (upper thick line):



Analyzing the evolution of the capital in the banking system, attention should be drawn to the positive aspect related to the distribution of capital among banks, or more exactly between groups of banks. In this context in the first group large commercial banks were included, which at 1.01.1996 had total capital bigger than the figure of 5% of total capital in banking system: Agroindbank, Petrolbank, Banca de Economii, Moldindconbank and Banca Socială. But in order to avoid a possible interference in this model, the Agroindbank was excluded (since at

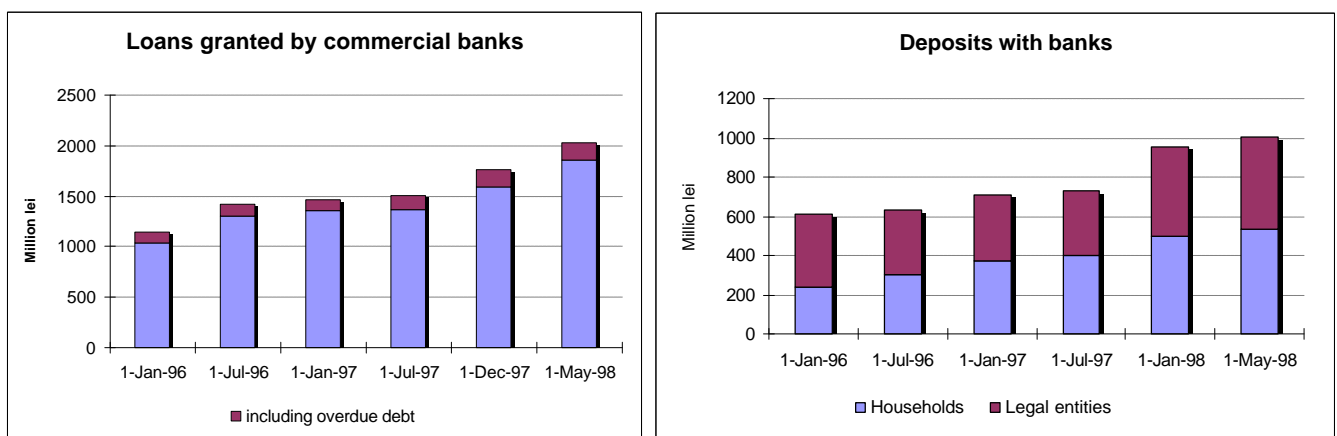
1.05.1998 the share of its capital in the total capital of the banking system was 30%). In the second group the remaining banks have been included.

The conclusion is the following: middle sized banks managed to gradually increase their capital, thus by end of 1996 balancing the capital of large banks, and advancing it afterwards. If at 1.01.1996 the ratio 4 large banks/small and medium banks was 1.17:1, then at 1.05.1998 it was already 1:1.59 – and this proves a substantial consolidation of the majority of middle sized banks, which are new commercial banks.



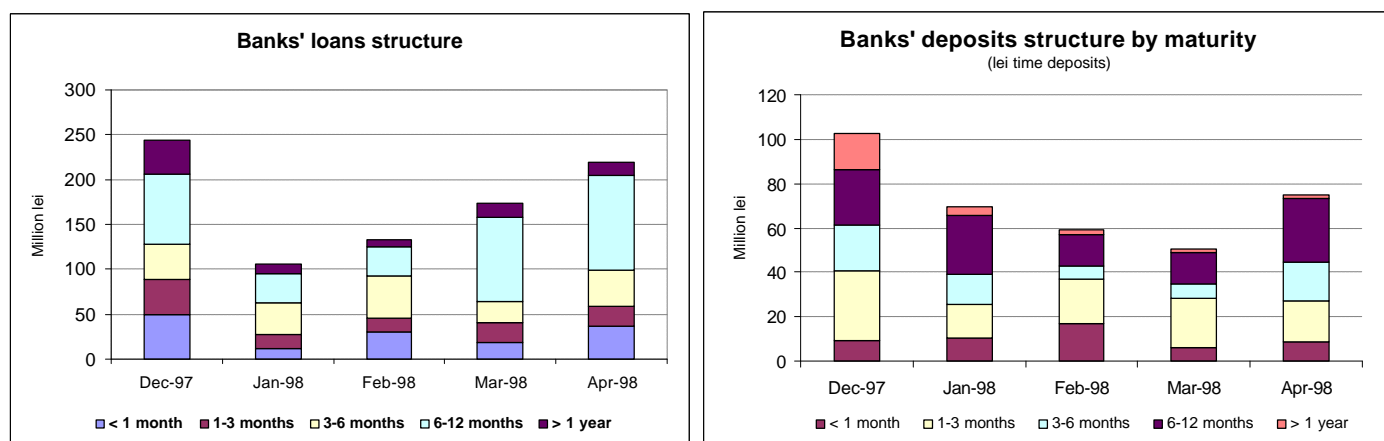
During the 1st quarter of 1998 loans granted by commercial banks have increased by 6%, reaching at 1.04.1998 lei 1.74 billion, out of which overdue debt accounts for 9.7%.

At the same time, the confidence of population in the banking system has increased, expressed by the continuous growth of deposits of individuals with banks. At 1 May 1998 they totaled lei 536m, which is 8.3% bigger than at the beginning of 1998 and 44.9% bigger than at 1 January 1997. During the same period (January-May 1998) deposits of legal entities have reduced slightly, influenced by the factor of seasonality, reaching at 1 May 1998 the same level as at the beginning of 1998.



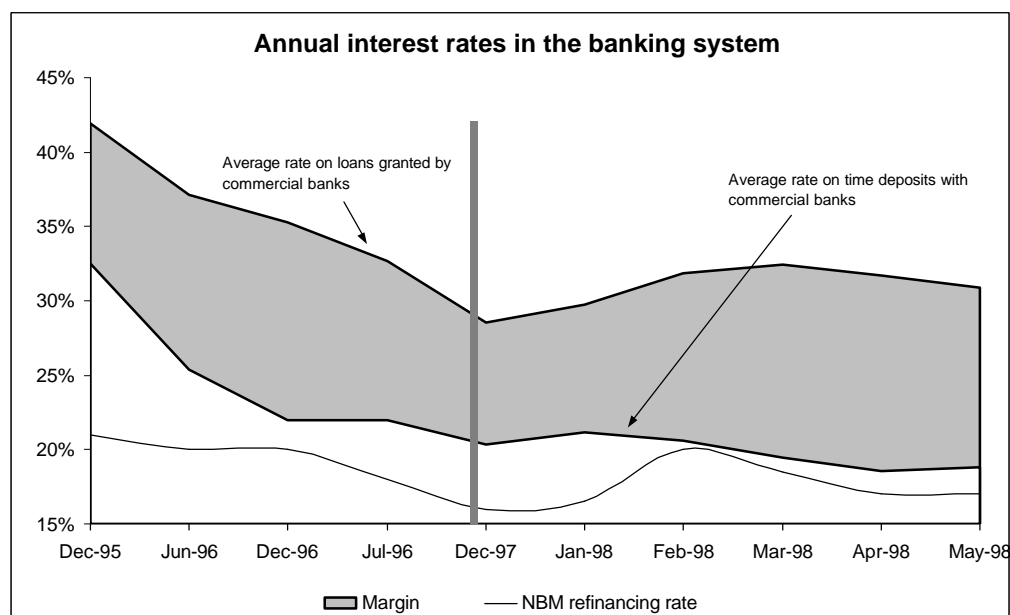
Analyzing the structure of commercial banks' loan portfolios and deposits in the 1st quarter of 1998 it should be pointed out that along with the growth of total volume of loans granted, driven by the seasonality factor, the share of loans granted for 6-12 months has increased: from 30% in January 1998 to 49% in April. Share of loans granted for more than 1 year did not vary essentially – it stood at 6-10%, but this is in its turn clearly explained by the structure of banks' deposits. If in December 1997 share of deposits with the term of more than 1 year accounted for 16%, then in April 1998 it diminished to 2%. Obviously, banks can not make long term credit investments when their clients' deposits are mainly short term. A very important role in this context have played the credit lines of the World Bank and EBRD for

private sector support and directed to the economic agents through commercial banks of Moldova.



It should be noted, also, that during the 1st quarter of 1998 sight deposits in lei have grown significantly – by 2.5 times, which shows that economic agents act successfully in the market, gaining profits. Regarding the structure of deposits by currency, it is to be said that during the same period the share of new deposits in foreign currency has somewhat decreased, banks' clients preferring placing deposits in lei.

As regards to the interest rates in the banking system, the following negative tendency has occurred: during the period of January-May 1998, along with the reduction of the refinancing rate, the banks' interest rate on deposits also gradually decreased, but at the same time banks' rate for loans granted did not fall accordingly. Therefore the margin had actually expanded (phenomenon also observed during 1996) from 8.2% in December 1997 up to 12.1% in May 1998.



The explication of this phenomenon is linked to a number of factors, out of which are especially systemic risk and some inflation expectations by banks, and not so much the tendency of profit maximization or lack of competition in the banking system.

Concluding remarks of this chapter:

Positive aspects:

- inflation rate continued to drop – cumulative value for January-May 1998 was only 2.5%;

- broad money has increased by 2.6% at the end of May 1998 comparing to the end of 1997, while deposits with banks grew by 12.5%;
- NBM's refinancing auctions have been stopped starting the second half of 1998, being replaced by open market operations;
- the share of state securities with maturity of 182 days and higher, sold by the MoF and NBM, grew;
- exchange rate of national currency is maintained stable, showing a slow nominal depreciation against US dollar;
- excessive real appreciation of Moldovan leu upon US dollar has diminished;
- situation in the banking system is considered to be generally positive;
- starting 1 January 1998 banks' minimal capital requirement was raised from 8 to 16 million lei, and respectively grew the total capital in banking system;
- capital adequacy ratio (total regulatory capital/risk-weighted assets) was increased from 6 to 8 percent;
- medium sized banks, which form the majority, are gradually strengthening;
- confidence of population in the banking system is raising, showed by the increase of deposits with banks.

Negative aspects:

- continuous increase of interest rates on state securities, generated by state's acute lack of financial resources;
- inflows from sales of state securities already do not cover the amounts needed for repayment of the previously issued securities;
- real effective exchange rate of Moldovan leu, i.e. upon currencies of Moldova's main trading partners, continued to appreciate in 1997, affecting to a certain extent the performance of Moldovan exports;
- BOP current account deficit reached in 1997 an extremely dangerous level of 16% of GDP, and BOP data for the 1st quarter of 1998 do not show any sign of improvement;
- NBM's foreign exchange reserves are declining dramatically during first half of 1998;
- accumulation of external debt continues – it grew by 3.4% during 1st quarter of 1998;
- the situation on servicing and repayment of foreign loans is aggravating, and the outflows needed for debt payments are already bigger than state's new external borrowing;
- because of bad economic performance of the country the credit rating of Moldova, assigned by Moody's and IBCA is expected to be diminished;
- share of long term loans granted by banks is small, and this is an outcome of mostly short term deposits in the banking system;
- during the first half of 1998 interest rates on state securities are considerably higher than banks' deposits rates, thus banks' clients' deposits being used for budget deficit financing, instead of being channeled into the productive sector;
- the margin between average lending rate banks' deposit rate grew, because banks kept high the interest rate on loans granted.

Final conclusion:

The country can not rely endlessly on the good will of external creditors without reforming its economy and getting out of the crisis. Without a firm implementation of reforms in real sector of the economy and reduction of critical public finances' disbalance, the stability of the monetary policy – of inflation rate and exchange rate of national currency – is on the way to failure.

2.3 Investment

Foreign Direct Investment (FDI) in Moldova remains sluggish, lagging well behind successful economies in transition. This chapter describes one of the possible ways to clear up the ground for strategic investors, namely by creating opportunities for the venture capital business. This commentary is based on the Western NIS Enterprise Fund (WNISEF) four-year experience in the region.

Why Moldova needs FDI

None doubts that a small economy in transition needs substantial external financial infusions. For the government of a country like Moldova trying to survive in a difficult economic environment, it is vitally important to encourage FDI. FDI has several obvious advantages over the portfolio investments or lending under sovereign guarantees: 1) is less speculative. FDI financial flows would not get reversed as easy as short speculative investments in T-bills or commercial papers 2) FDI is usually associated with the new technologies, know-how, training of the local staff, etc.

FDI will ultimately benefit the Moldovan infrastructure development in general, introducing new, much higher than previously, competitive standards for Moldovan companies and for the whole economy. This said, Moldova does not need to preserve all industries which existed under the previous centralized economy, but only those which can be self-sustainable and competitive by regional standards at least.

Despite energetic and sometime desperate efforts of four Moldovan governments to foster FDI, the foreign investors are not rushing up to invest their money in Moldova. The Moody's rating of Moldova which is still higher than one of its bigger neighbors - Romania and Ukraine, is a weak consolation since Moldova is at a comparable level of foreign investment with other FSU countries and well behind Baltic States, Czech, Hungary and Slovenia.

Why investors are not coming to Moldova?

There is not a clear answer to this question. Fundamentals like fiscal deficit reflected also in the foreign debt which is piling up rapidly, the current account deficit are worrisome, and Moody's rating is looking rather downward than upward. Altogether these phenomena are building up negative expectations. However strategic investors are probably more interested in the general assessment of the investment opportunities: general framework - rules of the game, written and mostly implied or how predictable the environment is, and ultimately and most importantly, whether there are possibilities to make money all inherent risks taken into account. On the negative side is the rent seeking as expressed in the euphemistic World Bank language and red tape which have become omnipresent in Moldova. On the other, positive side, Moldova has got the best government in years. Obviously the size of the market has to do something with this reluctance of foreign investors to shift gears. Also, the rule of thumb is the proximity to advanced economies which would create positive spillovers and benefit bilateral trade. Moldova's neighbors - Romania and Ukraine are not in the best economic shape to take the lead. Shall Moldova wait until these economies improve? Just waiting would be a quite cynical recommendation.

When a strategic investor WILL invest?

A strategic investor wants guarantees that his wealth will be preserved and expanded. He comes to the country for a substantial period of time, especially when capital intensive businesses are concerned. Therefore his caution is explicable. He is led by his instincts which tell him that Moldova is not on the list of first priorities. If he decides to go for some risk, he would be perhaps more confident if the risk is shared with someone he trusts. If he decides to create a joint-venture in Moldova or invest in the existing company, he wants to make sure that

the appropriate corporate management is enforced and the company is properly run, including financial control and monitoring. There are not many companies in Moldova which comply with these criteria.

What WILL a financial investor do?

Financial equity investors like European Bank for Reconstruction and Development or the Western NIS Enterprise Fund usually look at the much shorter time prospective than strategic investors. A financial investor would typically invest into a prospectively well-performing company, seek to achieve long-term appreciation of its market value and pass the stake into the company to a strategic investor.

WNISEF case study

The Western NIS Enterprise Fund is an investment fund capitalized at \$150 million by the United States Congress via the United States Agency for International Development (USAID). \$50 million have been committed to 19 companies through the Fund's early stage venture capital operations.

WNISEF invests in the share capital of privatized or new private companies or enterprises in Ukraine, Moldova and Belarus, and aiming at the strategic areas of the economic development of these countries. The investment is the first step of the collaboration between WNISEF and its local partner. The Fund does not require official guarantees from banks or insurance companies, although it may require personal guarantees from the management team and owners. In fact, the investment, although it is a time and efforts consuming procedure, is just the first step of the partnership. The WNISEF wants to have stable, devoted and professional partners, because after the investment is made, a tedious work starts requiring even more efforts. The WNISEF is providing different technical assistance programs at no cost for the company to help the management team to reach its targets. Our portfolio companies have found helpful especially programs in sales and marketing. We see our relationship with the management is the cornerstone of our success and want the management to be comfortable and constantly striving to improve because and due to the WNISEF's participation into the company. One of essential parts of WNISEF's value-added to portfolio companies is the Management Information System (MIS) which is installed at no cost for companies and ensures financial control and monitoring. It creates the transparency over the company's financials and helps the management to learn the modern way to manage an enterprise. WNISEF is frequently organizing seminars and training for CEOs and other key managers. But the most important is the WNISEF's staff personal involvement in the company's activities and strategic decisions. WNISEF stands by the management of the company, trying to help, advise or criticize.

WNISEF's main goal is to help the company to become a leader in the region and/or in its field. We do not ask for the payment of dividends to the shareholders, and support dividends' recapitalization which bolsters company's development.

Example

Agriculture Distribution Center(ADC)

ADC's mission is to provide high quality agricultural equipment and services, including custom farming, to agricultural enterprises in Moldova thereby replacing the previous state structures of supply and improving the agricultural productivity in Moldova.

To achieve this mission, ADC has signed a dealership agreement with AGCO Massey Ferguson giving ADC rights to sell and service AGCO Massey Ferguson equipment in Moldova. The custom service, equipment sales, parts, and service departments have been established. Key members of ADC management have been attending seminars and training courses sponsored by WNISEF while personnel associated with the sales and service of AGCO equipment are scheduled to receive intensive training from AGCO in the UK and Denmark. As a first step in marketing AGCO equipment, ADC held demonstrations of AGCO combines and

tractors at the international exhibition MoldAgro held in Chi°inu. Currently, ADC is in the process of implementing a management information system which will allow the company to produce IAS financial statements in 1998.

The main competitor for Agriculture Distribution Center is a company that owns 5 MDW combines, but ADC has a competitive advantage due to the fact that MF combine productivity and quality of services provided are superior.

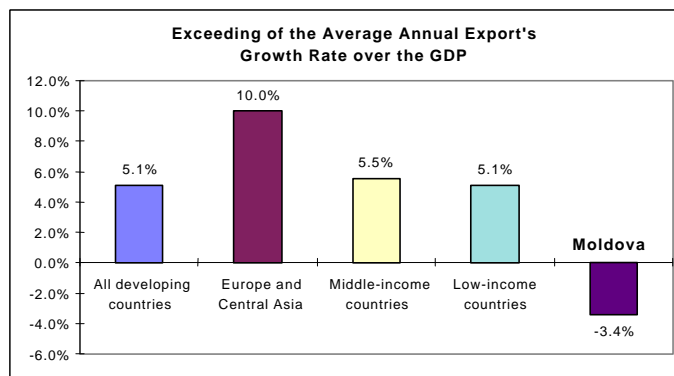
In addition, in 1997 twelve Case-combines were brought to Moldova under the governmental guarantee and were distributed between elevators that provide farms with harvesting services. View non-commercial status of these entities, they are not able to compete with Agriculture Distribution Center effectively.

2.4 External trade

Process of globalization and integration is the most important peculiarity of today's economy. Most countries promote policies of economic openness consciously. Since the beginning of 90's, Moldova, in certain circumstances, gradually oriented to the model of "small open economy", being in the search of its niche in the world. The foreign economic relations have a strategic importance for shifting to a more open economy, create premises for its stabilization and structural restructuring. The state must provide for a political and regulatory environment, including creation of financial and institutional infrastructure, conditions for attracting foreign investments and supporting export-oriented businesses.

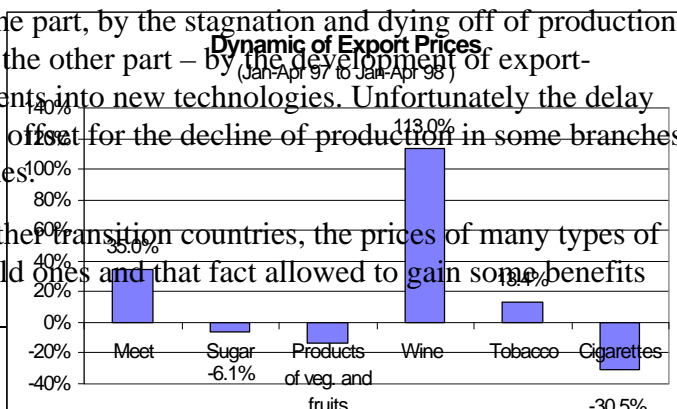
The sectoral structure of production, the composition and quality of Moldovan outputs gradually adapt to the market requirements – both internally and externally. However, during 1994-1997 the export index was constantly declining, whereas the average price of exports was growing faster (during those years more than twice). As a result, the export volume was growing from year to year, while the pace of its growth was gradually shrinking: from 32% in 1995 to 4.7% in 1997 (with the exception of the unique transaction of jets sale).

Along with the broadening economic openness of countries, many of them reached rates of exports growth prevailing upon the rates of GDP growth (see the graph). As shown in the picture, during the recent years Moldova's ratio of export to GDP was unsatisfactory. The situation in the neighboring countries is as follows: in Romania the annual rate of export growth above GDP constituted 19% (during 1990-1997), whereas in the Ukraine, during 1992-1996, this indicator was tracked to be negative: - 18%.



Moldova's development in the transition period is characterized, on the one part, by the stagnation and dying off of production, producing noncompetitive output, and, on the other part – by the development of export-oriented enterprises, that required investments into new technologies. Unfortunately the delay of enterprise restructuring did not allow to offset for the decline of production in some branches and by a growth in another, perspective ones.

Initially, in Moldova, as well as in other transition countries, the prices of many types of products were considerably below the world ones and that fact allowed to gain some benefits

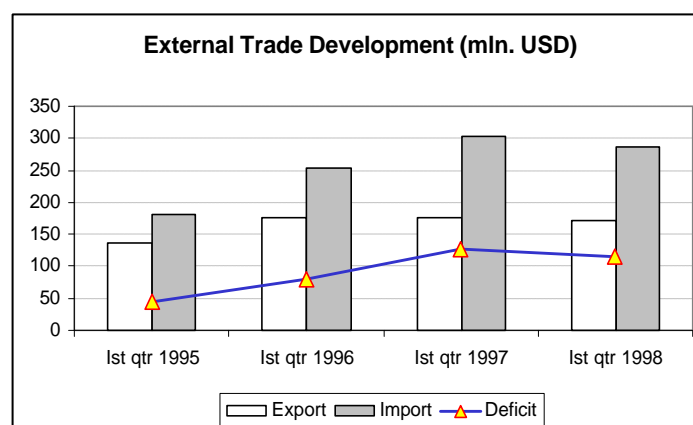


from the modification of trade conditions. During 1995-1997, owing to this factor, Moldova gained additionally US\$ 308 million. Other countries' experience show, that possibility of favorable change of trade conditions is a temporary occurrence, which is followed by particular tension in the economy. As of the beginning of 1998 the Moldova's reserves for export growth through increasing prices practically exhausted.

The modification of average prices of basic types of exported products during the first 4 months of 1998, as compared with the same period of the past year, are presented in the picture. The index of the physical volume of exports continued to decline. As a result of a low level of grapes harvest, the demand of wine considerably grew, which conditioned the growth of its export price by 113%. This growth considerably caused the fall of overall volume of exports, for the red wine accounts for 37% of the exports of the country. The positive aspect in the export of wine is, that the share of bottled wine sharply increased – from 42% to 83%. In case there is a good harvest in the forthcoming year, the price of exported wine will most probably decline.

In the early 90's, due to well known events in the CIS, in Moldova, the share of re-export within total exports was big (some 20-25%), which once with the regulation of the identification of the country of commodities' origin and development of partner countries' custom systems, in 1997 declined to 4.8% (according to calculations of the Ministry of Economy).

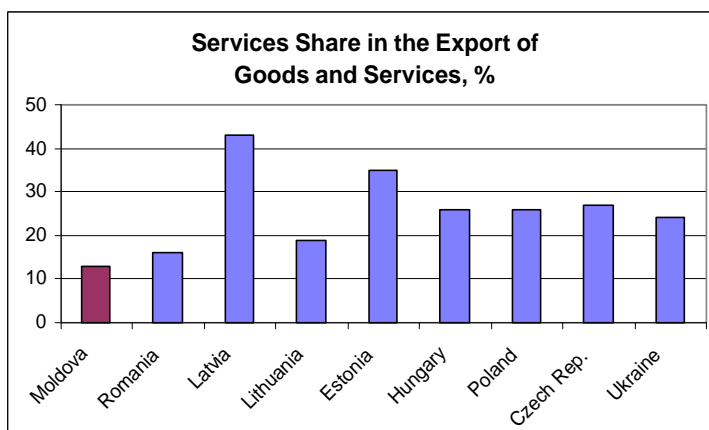
During the 1st quarter of 1998 the export of goods, produced in Moldova (except for re-export), fell by 7.6% as compared with the respective period of the previous year, during 4 months the export volume stood below that of the previous year by 2.2%. The fall of export was also tracked in terms of all groups of products, with the exception of food products, alcoholic beverages, tobacco and outputs made of them", that grew by 12.2%. Thus, the export opportunities more and more focus on ready made products, made based of domestic raw materials (grapes, fruits, vegetables and sugar beet). The scarcity of hard currency resources at the economic agents and a limited demand implied a diminish of imports in the studies period. A stabilization of the trade balance deficit is manifested, although its absolute value still remains very big (see the picture).



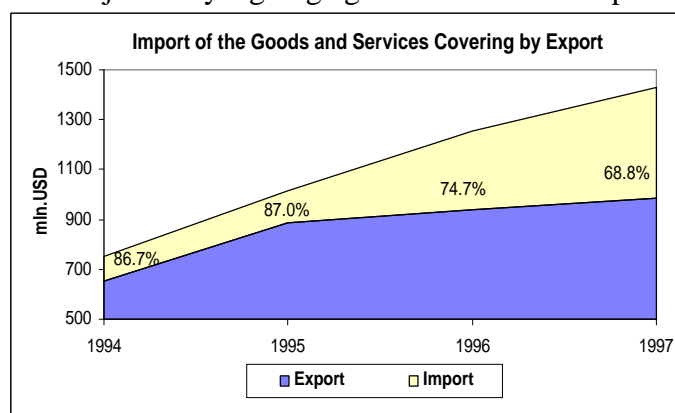
The diminish of exports could be explicated by the depletion of the row material base of the export oriented production (worsening of the state in viticulture, horticulture, tobacco – cultivation) and delaying of the restructuring the machine – building, light and furniture enterprises, which does not allow to escape from the colonial model of trade with energy and labor consuming goods. For the transition to trade with technologically more complicated goods the investing and producing growth of collaboration is needed. The restructuring of key enterprises, export promotion and the stimulation of import – substituting production are needed. As long as the amelioration of crises and restriction of the economy has a lengthy character, Moldova will have to work on the definition of its specialization in the international system of labor division.

In the modern world countries pay great attention to export of services, which in the international trade grow faster than export of goods: during the recent 15 years the average pace of service trade growth constituted 8% as compared with 6% of export of goods. In Moldova there haven't been created conditions for export of services, and thus, while export of goods grew by 15% in 1995, the export of services fell by 9%. In order to develop the export-oriented services, considerable investments are needed, including foreign ones, however, the inactive policy of the state in this field did not allow their attraction. Underdeveloped tourism, trade, poor quality and costly services in transports, communications and informatics engendered a deficit of trade balance of the country: in 1997 - US\$ 43 million, and in the 1st quarter of 1998 - more than US\$ 20 million. That is why, it is important to activate the policy of attracting investments into the service sector, oriented to export.

Comparing the share of exports of services within the overall Moldovan exports (13% in 1997) with those of a series of transition countries, one can notice the sharpness of the problem. During the last three years in Moldova comparatively faster have developed the export of services and informatics – by 2.2-fold, however, its absolute volumes are so far insignificant. When evaluating the export of services one should take into account, that the Moldovan balance of payments does not reflect the provided gas transit services, through high pressure pipeline, that should be adjusted by signing agreements with “Gasprom” on payment for transit of gas and on payment for gas by Moldovan consumers.



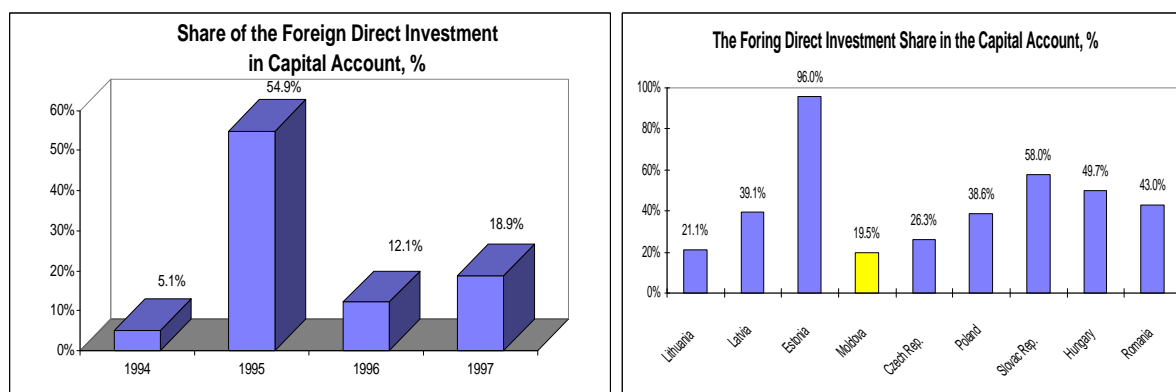
Starting since 1996 in Moldova the deficit of trade balance for goods and services sharply increased, which conditioned the growth of current account payment balance. International flows of capital for funding the economy of the country and international flows of goods and services are 2 sides of the matter. The deficit of trade balance of goods and services, *i.e.* positive balance of capital account points out the fact, that the country borrows financial resources from other countries.



The ratio of export and import of goods and services, as well as import coverage by exports are displayed in the picture. In 1997 the coverage level fell to 68.8%, which is less than the average indicator for low-income countries (72%). In fact all the countries at various periods of economic history use to either borrow capitals from abroad, or are lenders to other countries. And this is why, the deficit of current account not always reflects an unfavorable position of the country's economy. All the more, the transition countries are in objective need of inflow of capital for restructuring. Yet, the problem of Moldova does not consist in the growth of deficit of trade balance of goods and services as it is, but rather in the effectiveness of usage of foreign borrowings.

Given that the loans need to be remitted, by the time of loan maturity the country should

have its niche within international trade, this is why the foreign assistance must be directed first of all to increasing the effectiveness of exports structural and reforms of economy, as well as to changing the import structure in order to increase the share of fund generating produce, designed for modernization of production sector and enhancement of Moldovan output competitiveness. As of Jan. 1, 1998 the foreign debt of Moldova amounted to US\$ 1.2 billion, which accounted for 60% of GDP, and only an insignificant part of that was channeled to real economy sector.



Drawbacks in corporate management of privatized enterprises, lack of real owners with many of them, manifestation of “special interests” did not make possible so far to attract the required foreign direct investments (FDI) into the real sector of the economy. Their share within the overall finance inflow to Moldova is still very low. This indicator’s dynamics during the last years is displayed in the picture. Comparison of the share of direct foreign investments in the overall volume of loans in terms of various countries is displayed in the picture. For Moldova this indicator during 1994-1997 accounted for 19.5%, which is much less than with most countries in transition.

Given that during the years of macrostabilization in this country there was not created a basis for real sector growth, and consequently – of export potential, as well as limited the growth of export on the account of modification of the trade conditions, these factors can lead to a decline of exports already in 1998. Besides, there is a threat of worsening the import structure in terms of declining the share of fund generating products and increasing the consumer goods. That is why, urgent measures are required in order to create a favorable investment climate in the country. To mention is, that new Government Program for 1998-2001 the priority is mentioned of foreign economic relations development and export promotion.

Settlement of these tasks may contribute to:

- speeding up of Moldova’s joining in WTO and broadening relations with other international organizations;
- carrying out the policy of economic openness, removal of barriers hindering the flow of goods and capitals;
- concentration of capital with a view to activate its injection into restructuring the enterprises;
- stimulation of foreign capital attraction for setting up export oriented businesses;
- improvement of corporate management at the enterprises, improvement of legal basis aimed at protection of ownership rights;
- enhancement of human rights resources.

A series of measures designed for improving the foreign economic activity was included in the anti-crisis program, such as: setting up organizations for exports promotion, development of mechanisms for supporting exports, improvement of import structure and optimization of energy products consumption. Among them, the law “On anti-dumping, offsetting measures

and protection of producers” and leverage to control prices of imported products for avoiding dumping.

CHAPTER 3. ENTERPRISES' SECTOR: STRUCTURAL REFORMS

3.1 Industrial policy and enterprise restructuring

The implementation of a new, market-oriented industrial policy and enterprise sector restructuring is the key for the sustainability of Moldova's economic growth, which has hitherto heavily depended on the development of a highly volatile agricultural sector, the main sector of the national economy. Only the reform of the enterprise sector can in the long term provide the necessary resources for the economic and social security. Delay of enterprise sector reforming is one of the main reasons for budget deficit, inflation and unemployment. This reform is at the heart of the country's transition on its way to Europe and it basically means enabling and fostering an accelerated restructuring of enterprise sector according to its competitive advantages in the market.

The purpose of the industrial policy is to reach a *growth of competitive industrial output in terms of quality and prices and to expand the markets*. Being a small open economy, Moldova should move towards enhancing its industrial products' competitiveness on foreign markets, otherwise the economy has no chances to survive, and subsequently, the country is doomed to vegetating next to more developed countries of the Central and Western Europe.

The industrial policy is part of economic policy of the state. Unfortunately, the Government's *Concept of Industrial Policy of the Republic Moldova for 1996-2000 (Oct. 1996)* has not received due support by the Parliament (in terms of its legal basis and economic mechanisms). Industrial development is therefore proceeding relatively in a relatively unplanned and undirected manner.

The *Program of the Government for 1998-2001* stipulates, that the “strategic target of the industrial policy is to form a multi-sectoral high-tech and competitive industrial complex, which will provide for a sustainable development and economic independence of the country, for sufficient incomes and integration of Moldova into the system of world economic relationships”. The Government considers the *restructuring and further reform of the enterprises* as mostly important process of its period in the office.

Nevertheless by the middle of 1998 the situation in the industry is still serious. The enterprises are facing a lot of problems related to the following factors: high rate of barter transactions, low quality of products, high expenses per production unit, loss of traditional markets, high stocks of final goods, low level of production capacities use, enormous accounts receivable and payable, bank accounts blockage, high level of fixed assets depreciation after their reevaluation, decrease of working places. Currently 40 percent of the processing enterprises are non-profitable. The enterprise restructuring has become a necessary condition for developing Moldovan industry, because the foreign investors rate very high the risk of investing money in the enterprises that haven't been restructured yet.

The analysis has proved that the following additional conditions are necessary to speed-up and to promote successfully the restructuring process:

- to eliminate the barriers and obstacles related to the economic agents registration;
- to implement promptly the new accounting systems;
- to simplify the assets sales procedures;
- to launch new simple procedures of industrial land sales;

- to make rapid investments in entrepreneurial and managerial capacities through the Marshal Plan implementation, to use efficiently the technical assistance;
- to introduce special curricula related to the entrepreneurship in the universities;
- to reduce considerably the control bodies as well as the controls at the enterprises (nowadays there are about 60 bodies that have control functions);
- to make simpler and to solve the problems related to the access to credit resources (collateral, guarantees, sophisticated business plans), as well as to the examination terms for getting credits.

The stabilization of the situation in the Moldovan industry and the development of the restructuring process and financial recovery of the enterprises are not so fast. Several amendments to the existing laws and legal documents that create legal, social, economic and fiscal obstacles haven't been examined and adopted so far.

Legal

- The Civil Code – it is impossible to offer the state property as collateral and to force the execution of contract stipulations.
- The problem of making out a collateral for a credit (as well as of other documents) through the bodies of the Ministry of Justice.
- The delay in the implementation of the legislation on the privatization and sale of the land under the industrial enterprises.
- The delay of local administrative bodies in implementing the Government and Parliament decision on the transfer of social and cultural objects to the local administration.
- The slow privatization of the state property reduces the enterprise possibility to benefit from the World Bank credit lines that are offered to the private enterprises.
- The lack of a proper legal support in implementing management contracts.
- The procedure of motivating managers through buying a certain percent of enterprise shares is not defined clearly.

Fiscal

- The Value Added Tax (VAT) is applied to goods that are sold at a price lower than the production cost.
- The conditions concerning the use of 50 percent of the VAT to cover the restructuring expenses for the enterprises under restructuring are not executed.
- The enterprises are not stimulated to initiate restructuring activities because in 1997 the Parliament abolished the penalties of some enterprise without taking into consideration the results of their activity.

Finance and Accounting

- The assets are evaluated according to non-objective indicators. As a result the enterprise value is over-estimated.
- The production is delivered without payment on the basis of the indications of the respective Ministries. As a result accounts receivable are generated.

Production

- The Regulations on the Dutch Auctions do not allow commercializing the assets of the state enterprises.

Export and Import

- The customs procedures are too complicate.
- There are import duties for some raw materials.

Social

- The compensations in case of the personnel lay off when the enterprise is liquidated according the Government Decision ¹ 712 as of October 23, 1995 are made from the enterprise resources, not from the Social Fund.
- The unique subventions for the personnel who are laid off (equal to 5 medium salaries) from the resources of the Social Fund and from other sources are paid without any taxes.
- The losses generated by offering non-justified facilities to some representative of social groups are reduced.

In a series of branches (machine-building, light and construction materials construction industries), Moldova inherited from planned economy big large scale enterprises, that do not comply to market economy requirements. Small and middle enterprises are created basically in agricultural, trade and service sectors, whereas in industrial sector this process has not reached yet a proper level of development. For instance in Italy, Germany, France, Great Britain and USA, the enterprises with more than 100 employees absorb about 58% of the manpower of those countries and generate 50-62% of GDP; for Moldova these indicators respectively account for 12 and 15%.

At first stage of restructuring process is based on the principle of large enterprise break-up (by selling some idling assets, by dividing into viable units, which also do not affect the technologic process ("break-ups", "spin-offs"), leasing out and offering on tenancy of industrial sites to private sector, with a view to set up small and middle enterprises (SMEs) and generate new jobs.

In the beginning of 1998, the Government approved the State Program of Small Business Support for 1998-2000, yet it still remains subject to ratification by the Parliament. Also, the expenditures required for small business support are not stipulated in the current budget. Business start-up, operation and liquidation are still discouraged by numerous bureaucratic hindrances and endless directives regulating business activity and often stimulating corruption.

The need to develop small and middle enterprises is determined by a series of advantages: receptivity to constantly changing market requirements, declining production costs, enhancement of management effectiveness, possibility to use for technical reequipment of enterprises relatively low volumes of cash, broadening possibilities to attract foreign investments.

The broadening of small and middle enterprise sector will set up an environment for a competitive market, avoiding monopolistic pricing, whereas the employees of these enterprises create a new social group – the middle class – and to a great extent contribute to social stability in the society.

The initial experience of large enterprise division was accumulated on the basis of joint-stock company "Mashfrigocomplect" (Străeni) and joint-stock company "Alfa" (Chişinău). 25 private enterprises have been created on the basis of joint-stock company "Mashfrigocomplect"; the joint-stock company "Alfa" was the first major manufacturer to which the Law on Bankruptcy was applied, on the basis of which 34 private enterprises have started operations. The "Alfa" joint-stock company will be receiving from these activities about 2.5 million lei annually.

A new and innovative form of small and medium-size business development is industrial technological park. In February 1998, the Parliament enacted legislation on the creation of three free enterprise zones - techno-parks "Vulcăneşti", "Taraclia" and "Otaci-Business", formed on the basis of the loss-making enterprises and their infrastructures.

The Agency for Restructuring and Enterprise Assistance (ARIA) has been created to support Government efforts in accelerating the program of structural changes in industrial and

financial sectors. The Agency has been involved at the implementation of the following enterprise restructuring projects: *Pilot Project*, *Private Sector Development Project (PSD-I)*, and *Assistance to the Enterprise Isolation Project*.

At the beginning of 1998 enterprises of the *Pilot Project* (Stejaur, Spectrul, Farmaco, Nistru, Flamingo, MFC, Zorile, Piele, Moldagrotehnica, Tricon, Incoma°, Bălăneanca) have achieved the following performance.

The above enterprises are acting in the third year of restructuring. Positive restructuring results have been achieved at 9 enterprises and at newly created small companies of the MFC Industrial Park from Străeni. There is an improvement of all economic and financial indicators: growth in output and sales were registered at 9 enterprises (in average by 16% and 30% consecutively). Barter transactions have been reduced (by 9%), export has increased, and labor productivity went up by 30%. 8 of the total number of enterprises managed to significantly decrease costs and energy consumption; stocks reduced at 7 enterprises (by 16-38%). Enterprises are collecting outstanding accounts receivable, are selling unused assets and fulfilling current obligations.

There has been achieved positive results and sales increase at 9 enterprises (except “Spectrul” and “Nistru”, Sorocea, which was proposed to liquidation) from the total number of enterprises of the Pilot Project: output volume increased at 8 enterprises, and as a result turnover indicators are better at the following enterprises: Zorile - by 17%, Piele - by 35%, Moldagrotehnica - by 49%, Incoma° - by 14%, Farmaco - by 30%, Flamingo – by 112%, Tricon – by 17%.

Accounts receivables have been reduced by 1.2 million lei at 8 enterprises as a result of measures for their collection. The majority of enterprises managed to reduce Accounts payable (approximately 16 million lei in total). As a result of fixed assets optimization programs in 1997 9 enterprises sold over 9 million lei of unused assets, and generated cash for debt repayment and working capital.

There are 15 more enterprises restructured by ARIA under *PSD-I Project*, out of which 10 are at a stage of the restructuring plan implementation. At “Alfa-Nistru” S.A. and “Ionel” S.A. the implementation of Management Information System (MIS) is finalized. “Alfa” is reorganized in Industrial Park. Economic Court has initiated a bankruptcy through liquidation procedure against “Chi°inâu Glass Factory” S.A., “Speranța” S.A., from Dondu°eni is also liquidated according to the Law on Bankruptcy. 39 new entities and 59 lease companies have been established at the above mentioned enterprises.

The analysis has been carried out by grouping the enterprises into 3 categories: *1st group* (Ionel, Alfa-Nistru, Conserve-Orhei, Dana, Intreprinderea de colectare (Donduseni), Centrul de moda) – enterprises with substantial results; *2nd group* (Faprochim, ICAM, Elcas, Donduseni-Zahar, Prut-Falesti) – enterprises meeting some difficulties in the restructuring process; *3rd group* (Alfa, Covoare-Ungheni, Chi°inâu Glass Factory, Speranța-Dondu°eni) – enterprises reorganized according to the Law on Bankruptcy.

Economic activity of the enterprises and results of the implementation of the restructuring programs after the first quarter of 1998 showed some good performance.

Growth in output and sales has been observed at the majority of enterprises: for the enterprises from the *1st group* – sales increased by 21%, *2nd group* – by 1% and *3rd group* – a reduction by 75%. Output at the enterprises from the *1st group* has increase in average by 32%. Turnover increased significantly at “Dana” S.A. (2 times), “Ionel” S.A. (by 29%), “Orhei Cannery” S.A. (by 18%), “Alfa-Nistru” S.A. (by 15%).

At the enterprises, which are registering success – new working places are being created – the number of employees increased by 7%, which means 245 new working places (at the enterprises from the *1st group*). At the same time there was registered lay-off of about 442 persons at the enterprises that are meeting problems or liquidated.

Labor productivity at the enterprises from the group 1 increased in average by 42% and from the group 2 by 8%. This indicator improved significantly at 9 enterprises: “Ionel” S.A. and

Centrul de Modă - by 2 times, at "Elcas" S.A. - by 1.5 times, "Alfa-Nistru" - 1.4 times. At 90% of the restructured companies average salaries went up. The most substantial results in this field were achieved by "Ionel" S.A. - from 183 lei to 662 lei, "Conserve Orhei" S.A. - from 182 lei to 597 lei.

Half of the restructured companies are accurately fulfilling current payment obligations and the enterprises from the 1st and some from the 2nd group - repayment of old debt to the creditors. Short term debt significantly decreased by 35 million lei in total, or by 11%, including 2% for the 1st group and 18% for the 2nd. Companies classified in the 1st group are registering profit, which is substantially higher than for the previous period: operational profit accounts over 12 million lei, which mean an increase of more than 7.7 times. Net profit registers an increase of 2.6 times compared to the results of the previous year.

8 enterprises sold during first quarter of 1998 non-utilized assets amounting to 714 thousand lei - during the previous period this indicator was 916 thousand lei. Stocks have been reduced in average by 4%: at "Conserve-Orhei" - by 4.7 million lei, "Elcas" S.A. - by 4.1 million lei, "Donduseni-zahăr" S.A. - by 4.6 million lei, "Prut-Fălești" S.A. - by 0.9 million lei.

The Project Assistance to the Enterprise Isolation Project (financed by TACIS) at 5 enterprises: Macon, Moldcarton, Faconis, Incomlac, Agroma^oina was launched on October 25, 1997. At each of these enterprises around 20 restructuring programs have been implemented. Three companies registered success during the implementation: Macon, Moldcarton and Incomlac. Turnover at Moldcarton has increased by 58%, at Macon - by 15%. Incomlac has implemented a new system of cost management and an advanced network for raw material collection.

With the purpose to improve the efficiency of enterprise management and especially their capability to adjust to demand developments on the domestic and foreign markets, a Competitiveness and Productivity Center has been created, within the framework of the *PSD-II Project*. During the time of project preparation, 22 managers had 2 to 4-month training in UK and Slovenia. Training of another 300-400 Moldovan managers is in the process of being organized.

State support for enterprise restructuring is carried out through the memoranda of the Creditors Board. Since May of 1995, the Board has developed a procedure of isolation for implementation of the restructuring plans, with the deferral of debts, for 132 economic entities. By April 1, 1998, memoranda have been signed with 96 enterprises (about half of them - industrial), debts worth of 669.7 million lei deferred. This makes more than 30% of the total debt of all enterprises and organizations to the budget and extra-budgetary funds.

One of the most baffling problems for enterprises are their long-standing debts. Their accumulation was largely determined by inflation in 1991-1992 and errors in the state management policy. Existing legislation now provides for the write-off of such debts, provided the debtors effect current payments to the budget and Social Fund in a timely fashion.

Financial standing of the majority of the enterprises operating under the terms of the memoranda has improved: the volume of sold production for cash rose and accounted for 52% of the sales volume; more than 62% of profits (131.4 million) have been allocated to development of production; idling assets have been sold in amount of 185.3 million lei, more than 50% of this amount was channeled to complementing the working capital, 49% of the frozen arrears has been paid already to creditors. With a view to release the enterprises from functions not characteristic to them and speeding up the pay-off of their arrears, the Creditors Board approved transition of 88 social-cultural objects, valued at lei 60.5m, to the balance-sheet of the local authorities.

However, a number of enterprises have failed to comply with the terms of these agreements and, since the beginning of 1998, the number of the enterprises under the memoranda decreased to 26 units.

A tremendous qualitative change in Government's approaches to industrial problems - unfeasible, loss-making and debt-accumulating enterprises should undergo through the

procedure of bankruptcy. For the first five months of 1998, the Law on Bankruptcy has already affected some 40 enterprises. However, the shortcomings of this piece of legislation serve as obstacles in restructuring of enterprises: there is no precise definition of the competence and responsibilities of each of the parties involved (e.g. government and ministry); there is no precise regulation and mechanism of relationships between the Creditors Board, the manager and the proprietor-debtor; nothing is said about deliberate bankruptcy and responsibility of the manager in such an event; there is a number of discrepancies between different articles of the Law and some articles stand in contradiction to other legislation. Unrealistically high demands to and responsibilities of the manager and low stimuli in his/her work, the impossibility of sale of buildings and structures without privatization of the land they are located on - all this also interferes with implementation of bankruptcy procedures. Improvement of the mechanism of bankruptcy processing in the shortest possible terms is at this time a key task of the Government and Parliament.

The problem of corporate management remains a serious impediment on the way of successful industrial development. After privatization for Patrimonial Bonds, there is a huge number of shareholders, but not real proprietors. A significant share of privatized property is owned by privatization/investment funds (PIFs), of which at least one third 'lives off' the enterprises.

The Government should support the tendencies toward the concentration of capital. A positive example - PIFs "Agrofond" and "Dividend" together with the enterprises in which they have shares, have created an association of mutual crediting in charge of capital investment.

There is a tendency, on the part of some managers, to keep the 'outside' shareholders outside of running the enterprise. The mechanism of protection of the proprietors' rights remains to be underelaborated, which results in losses in some enterprises. The cases of withdrawing of outsiders' resources from the enterprise to other firms to the detriment of other shareholders and PIFs are at the same time observed. It is necessary to create a system of effective legal protection of the shareholders against actions of the managers that are damaging to the enterprise and the shareholders.

For the nearest future, the main problems in the industrial sector remain to be: increasing of competitiveness and productivity, export promotion, introduction of advanced technologies, and management training.

3.2 Energy sector: restructuring and preparation for privatization

One of the strategic targets of the national economy is to diminish the power-consumption within GNP and improve the energy balance. Starting from 1997, in the Republic of Moldova a complex of measures is implemented aimed at restructuring the energy sector, including:

1. Approving the Restructuring Plan of the energy sector (Government Decision no. 628 from 08.07.1997). The principles of reorganization of the State Company "Moldenergo", objectives, stages and privatization methods of these subdivisions were determined. Elaboration and approving the Regulation of the National Agency for Energy Regulation- ANRE (Governmental Decision no. 767 from 11.08.1997);

2. Approving the Concept of Privatization of the enterprises from the energy sector (Governmental Decision no. 260 from 09.03.1998). The objectives, principles and mechanisms of privatization of 8 energy companies, activities related to their preparation for privatization (methods of patrimony evaluation, preparation of documents for the tender, evaluation and negotiation of the offers).

Approving the regulation of the private companies for collection of accounts receivable of the energy sector (Decision of the Government no. 309 from 19.03.1998) and of quick

measures for paying of debts of budget institutions to the energy enterprises (Decision of the Government no. 1110 from 01.12.1997);

3. Approving the plan of restructuring of debts of energy sector (Decision of the Government no. 547 from 12.06.1997). Mechanism and concrete measures were determined: mutual payments, covering the costs and a part of historical debts based on tariffs' increase, conversion of the expired short-term obligations into long-term debts, decreasing the level of barter transactions, creation of private companies for collection of the debts;

4. Increasing the tariffs for electric, thermal energy and natural gases in order to cover the costs (Government Decisions no. 231 from 05.03.1997, no. 512 from 05.06.1997, ANRE project from 17.04.1998 which was temporary suspended with the Governmental disposition until determination of social protection measures);

5. Creation on the basis of State Company "Moldenergo" of 14 Joint-Stock Companies and of the State Company "Moldtranselectro" (Decision of the Government no. 1059 from 13.11.1997). The result is the improvement in operation of the energy companies, in energy supply and collections of payments for the consumed energy. In 1997 the ratio of collection of payments for the energy consumption overlapped 100%. At the same time accounts receivable decreased with 29% which is 34 million lei (this tendency is not confirmed in 1998);

6. Approving additional measures for monitoring the debts and improving the financial situation of the companies from the energy sector (Decision of the Government no. 325 from 20.03.1998). The terms and conditions of rescheduling the debts, disconnection of the non-payers, stimulation of the managers in order to improve the collections and reduction of the barter operations were established. Approving the mechanisms for monitoring the preparation of the companies for privatization – Governmental Committee (Decision of the Government no. 207 from 27.02.1998) and control on restructuring the debts of the sector – State Committee for supervising the fulfillment of stipulations of Governmental Decision no. 547 from 12.06.1997);

7. Delimitation of the functions and responsibilities of different State bodies and consulting companies (ARIA, Abt Associates and Hagler Bailly) of terms of implementation of privatization project at enterprises from energy sector (Agreement of Co-operation from 02.02.1998). Open public sessions concerning issuing the licenses to the energy companies. There were already issued licenses to 12 companies (3 production companies, 5 distribution companies and 4 independent suppliers).

The above-mentioned activities laid the beginning of the promotion of the restructuring project of the sector, creating legal basis, informational and regulation framework, necessary economic and financial mechanisms. At the same time uncertainty and inconvenience of activities of institutions from public administration, controversial approaches in the stringent problems made, in many aspects, more difficult the process of improving the situation of these enterprises, of their restructuring in the pre-privatization phase.

Economical and the financial situation of enterprises from energy sector. In the financial restructuring the energy sector in May 1998 a detailed diagnostic analysis of the economic and financial situation of 8 enterprises from this sector was done (ARIA). The main objectives of this study were:

Determination in details of the financial and economic status of each enterprise, including accounts receivable and accounts payable (as of January 1, 1998 and April 1, 1998), the structure and trends of these debts and elaboration of a plan for their monitoring;

Detailed examination of the deliveries and collections in the energetic enterprises, including the trends of the barter operations;

Examination of losses, including commercial losses and non-payments, and elaboration of some concrete measures to diminish these losses;

Analysis of company's costs and their trends;

Determination and analysis of the main performance indicators of the company.

The main problems the energy companies are facing at the moment are: drastic decrease of the collections, high commercial losses (energy stealing), inappropriate distribution of the historical debts, high share of barter transactions, non-payments permanently increasing. The financial and economic analysis of the companies included in the project of restructuring of the energetic sector revealed the following.

The situation as of the beginning of 1998 can be described with the increase of the sales volumes (exception – CET 2), accounts payable dramatically increased (+29%), increase of the accounts receivable (+46%) due to a low percentage of payments for the supplied electricity (*see Table 3.2.1*).

The accounts payable of the companies for the first quarter of 1998 also have increased. Some companies have accounts payable 3-5 times higher than accounts receivable and the difference is enlarging (RED Nord, RED Centru, RED Sud). This tendency is alertness and if the increasing difference is not stopped it can put in danger the entire privatization process.

One of the biggest problems of the newly founded Joint Stock Companies is that after the State Company “Moldenergo” suspended its activity all the accounts payable, which occurred as a result of activity in the previous periods were transferred to the balance of the energetic companies (1028 thousand lei at 01.01.1998). Such a burden does not permit to the Joint Stock Companies to become self-sustained.

The companies do not have the possibility to payback these huge historical debts which are to be reallocated before privatization (currently ARIA together with Abt Associates and Energy Department are working on the project of the corresponding Governmental Decision). Because of negative profitability, companies generate additional losses from their operational activity (*see Table 3.2.2*). The main reason of these losses is that the costs for 1 kWh of delivered/recorded energy (delivered energy minus technical and commercial losses and non-payments) are bigger than the tariff.

The general situation at CETs (Thermal-Power Stations) is critical too. It is influenced by the non-payments during the heating period of 1997-1998. At the same time preparation for the heating season of 1998-1999 need big financial resources (CET-I - 40 million lei. CET-2 - 70 million lei and CET Nord - 40 million lei).

Table 3.2.2 Performance indicators of the energy companies, April 1998

Indicator	RED Chi'inău	RED Centru	RED Nord	RED Nord Vest	RED Sud	CET 1	CET 2	CET Nord
Net profit/Loss, Mil lei	1.4	- 21.0	- 22.5	- 13.7	- 18.2	- 9.4	- 9.7	- 12.7
Profitability of Sales, %	0.35	-65.0	- 25.0	- 60.0	- 91	- 24.1	-7.0	- 72.0
Cost of 1 kWh delivered/recorded, bani	23.1	36.3	33.3	35.3	38.7	7.2	9.97	11.2
Tariff for 1 kWh, Bani	24.0	24.0	24.0	24.0	24.0	10.3	13.37	12.6
Costs for 1 leu recorded energy, lei	1.01	1.76	1.25	1.68	1.93	1.24	1.07	1.88
Total Losses, (% from kWh)	14.6	43.8	41.0	40.7	46.8	-	-	-
Commercial losses and non-payers, %	2.9	31.8	29.0	29.7	29.8	-	-	-
Tariff for 1 Gcal, lei	-	-	-	-	-	51.0	51.0	51.0
Costs of 1 Gcal, lei	-	-	-	-	-	72.0	78.8	93.8

Lack of financial resources (due to a very low level of collected payments for rendered services) does not allow to make the normative reparation and to purchase the fuel necessary for the following autumn-winter season.

Basic measures that have to be undertaken in order to decrease the accounts payable:

- collecting in time of the bills for the delivered energy and disconnection of all non-payers starting with June this year;
- minimization of the volume of commercial losses (energy stealing) which influence the costs and cannot be covered by the tariff. In order to solve this problem huge investments are needed. They cannot be generated by the distribution companies;
- application of a common tariff for the electric power for all categories of consumers, in parallel with elimination of privileges and compensations to privileged categories of customers (see Chart 6). Subventions must be nominative – paid directly from the budget to the customers and not through energy companies, like it is done today;
- adjusting the tariff for the thermal energy. The analysis shows that the production cost is 20-25% higher than the existent tariff. This fact causes considerable losses in production of thermal energy, characteristic for the thermal-power stations from the republic. This situation is also influenced by the non-payment of the customers – mediators of thermal energy (ex: RAPDET in case of CET-1 and CET-2). It is proposed that ANRE during one month is adjusting the tariff for the thermal energy in order to cover the expenses generated by the production of this energy. This study was done by ANRE on April 17, 1998 and presented to the Government, which approved a set of measures of social insurance until June 20, 1998.

There are measures proposed to reduce the commercial losses (ex: changing of meters and cables) the effect of which could be the reduction of these losses, but these measures need considerable capital investments. The same situation is with the technical losses, a big part of which appears because the equipment is not used at its nominal capacity. It is proposed to include the investment plans of the distribution companies in the tender documents.

Basic measures related to the decrease of accounts receivable. During the activity of newly created Joint Stock Companies in the period of the first quarter of 1998 the accounts receivable were in a permanent increase. Reasons of this tendency are: insolvency of economic entities, as well as of the individuals, which leads to inability of the above-mentioned to honor their current obligations; collecting the payments for the delivered energy worsened; in spite of the fact that the number of the disconnected consumers increases, rescheduling of the accounts receivable, even in the case of some small amounts leads to postponing the payments for the rescheduled debts, as well as for the current obligations; nowadays the mechanism of collecting the debts using the private companies is used partially (at RED Nord Vest such a company collected 98% with a commission of 4%).

In order to change the current situation the following have to be undertaken:

- disconnecting of 100% of clients which does not pay their bills starting with June this year;
- unconditioned disconnection of the customers which concluded memorandum – agreements for rescheduling the debts to the energy companies, but do not pay the rescheduled or current sums;
- involving in collection of the accounts receivable of the private companies applying the method of pre-established payments for an established quote and extra payments for the additional collections (in accordance with the Governmental Decision no. 309 from March 19, 1998);
- initiating the bankruptcy procedure for the insolvent customers.

The general trend of the barter operations is in decrease. For instance at RED Centru the share of barter transactions went down from 71% in January to 57% in April, 1998. Average for all 8 enterprises is the following: 65.8% in I quarter of 1998 compared to 80.9% in IV quarter of 1997.

Internal measures. In order to change the economic and financial situation in energy enterprises the following additional measures are proposed:

- enforcing contracts relationships between suppliers and consumers;
- implementation of new organizational structures and of new job descriptions for the employees, elaboration of motivation schemes for the company's employees;
- selling of the unused assets;
- elaboration of the schedules for reduction of barter operations up to the full elimination; elaboration and implementation of the programs for the reduction of losses;
- training of the company's staff in new techniques for operation in the new economic environment.

Based on the suggested measures, ARIA is finalizing the restructuring plans (until June 1998), that have to be submitted for approval to the Council of Creditors.

Measures in competence of Parliament, Government, concerned Ministries and Departments. A set on measures related to amendments and additions to the legislative

framework of financial restructuring and privatization of the enterprises from the energy sector should be promoted until August 1998. The mechanisms for the implementation of these measures approved by the Government Resolutions should be adjusted to the new realities. At the same time a set of activities related to the elaboration of the Informational Memorandum for investors, tender documents, conference with the potential investors with announcement of pre-selection, as well as the modalities of creating and operation of new mechanisms for re-distribution and monitoring of the debts have to be examined.

In accordance with this purpose the following is proposed:

a) The Parliament has to adopt the following legislative acts:

Law about electric energy (in second reading);

Law about natural Gases (in second reading);

Decision about the Privatization Concept of the enterprises from the energy sector (was approved by the Government by Decision no. 260 from March 9, 1998);

Decision about the reallocation of the historical accounts payable transferred from the balance of the newly created energy companies to an institution founded under the Ministry of Finance;

Decision about the Individual Privatization Plan for enterprises from the energy sector.

b) The Government adopts the following decisions:

About modifications of Legislative Acts and Presidential Decrees which granted privileges to some groups of consumers (there were amendments included in this project and it was passed to the Government for examination in January 1998);

About modification of Governmental decisions related to establishment of strong financial discipline in budget institutions and State companies debtors of the energy companies (Decision no. 325 from March 20, 1998);

About approval of the statutes for the State Enterprise Moldtranselectro ;

About making official the statutes of the National Agency for Regulation in Energy Sector (ANRE) as an independent institution, as it is stipulated in the project of the Law concerning the electric energy (this decision could help ANRE to carry out its obligations in accordance with its Statutes and without additional coordination.

c) Examination by the Governmental Committee for Supervising the Privatization Process of the companies from the energy sector (Decision of the Government no. 207 from February 24, 1998) of the following documents:

Strategy and modality of privatization of the enterprises from the energy sector;

Mechanisms for consolidation of the financial discipline and responsibilities of decision makers in the implementation of the plans for debts monitoring;

Concerning reallocation of the historical accounts payable from the balance of the newly created enterprises from the energy sector to a new founded institution under the Ministry of Finance;

Informational Memorandum, tender documentation and the agenda of the investment conference.

3.3 Land reform and farm restructuring

Transition adjustments and tendencies

Moldova's specialization in agricultural production has been determined by favorable weather conditions and above average fertility of agricultural land (75% of all soils are chernozioms). Agriculture is indeed the backbone of Moldovan economy, as it holds a 38% share in GDP, provides employment to over 42% of active labor force, and accounts for nearly three quarters of total exports of the country. Taking also into account the size of agricultural area (75% of total) and the high proportion of rural population, there is no doubt that successful land reform along with a correctly determined and clearly defined agricultural policy would lead to the well-being of the population and the overall improvement of the economic performance of the country.

Since the transition the main *macro tendencies* observed within the agricultural sector can be summarized as follows:

- Reduction in production and yields;
- Change in the structure of product mix, as the share of crop production continuously increases since 1990;
- Increase of areas under labor intensive crops with guaranteed markets and low production costs, and decrease of areas under resource intensive crops;
- Movement of production from collective to individual farming;
- Fall in consumption of main food products followed by the problem of production surpluses;
- Clear breakdown in former collection and distribution network and persisting difficulties in establishing new marketing channels for farm inputs and outputs;
- Low (often negative) profitability of large farm enterprises, low tax compliance and highly exaggerated and ineffective state subsidies granted to large scale farms;
- Insufficient access to credits, as well as extension services for small private units;
- No investment in rural social services and extremely low standard of living of rural population;
- Fall in capacity use of processing enterprises;
- Inadequate price structure when production costs exceed producer prices;
- Fall in agricultural export volumes and increased flow of imported food products.

The overall decline was mainly caused by the financial crisis within the agricultural sector, which provoked a sharp drop in the output of large farm enterprises. Thus, between 1990 and 1996 the land in corporate sector declined by 25%, while its gross product dropped by 65%.

The lack of financial resources has made the agricultural enterprises to apply simplified technologies of production and, as a result, their productivity decreased by 30-40%, the soil fertility has reduced: in 1996 chemical fertilizer use has declined 17 times (as compared to top-year 1985), while potassium and phosphorous based fertilizers are almost not used due to high

cost and lack of availability. However, according to European standards, the country disposes of a strong potential for growth in agriculture.

Meanwhile, starting with 1996 the individual sector, holding a 18% share of land area, produces more than half of total agricultural output.

Changes in Land and Asset Ownership

The first task of agricultural reform, which is the *elimination of state monopoly on ownership of land*, had been given a start in 1992 and developed slowly and uncertainly until early 1996, when most of bureaucratic and technical constraints have been removed from the legislation. Now many fundamental changes are taking place in the sector organization, including, first of all, the distribution of land titles ("land shares"), and, in parallel, physical allocation of land plots to individuals and families who exit from the large farms. Thus, by April 1998, 95% of entitled individuals have already received provisional ownership certificates, and 71% of people who applied were allocated land in private ownership. An important issue in this context is that only 27% of entitled individuals have actually applied for physical allocation of land plots (278 thousand out of 1 million beneficiaries)¹. Although the privatization rate² strongly differs across districts, one fact is certain: it steadily rises over time.

Privatization Rate by Zone (%): 1996-1998

	<i>October 1996</i>	<i>October 1997</i>	<i>January 1998</i>	<i>April 1998</i>
North	3.2	7.5	8.4	10.1
Center	24.8	30.0	30.5	33.6
South	4.9	8.9	10.8	12.2
National average	11.2	16.1	17.0	19.2

Source: Department of Department of Statistical and Sociological Analysis

According to cadastral land balance as of January 1, 1998, individual sector in Moldova manages about 21% of agricultural land, and the rest is controlled by various large-scale structures, most of which are not yet restructured. However, the increase of peasant farms' share is quite essential (7.8%,) as compared to the one in 1994 -0.7%.

In addition to that it is necessary to mention of the development of a range of other ownership relations:

- The state holds ownership of 17% of agricultural land (435 thousand ha out of total 2.6 million ha), of which 358 thousand ha is in a reserve fund for future needs (in fact, leased to various producers), and only 77 thousand ha is permanently allocated to state agricultural enterprises.

- Of 2.2 million ha in private ownership (82% of agricultural land), individuals cultivate about 500 thousand ha (or 20%), which includes land in household plots and in independent peasant farms.

- The remaining 61% of agricultural land is managed by large-scale farm enterprises, some of which are still registered as traditional collective farms (387 thousand ha), while others are organized in various new forms, which represent join-stock structures based on collective farming: joint stock companies, agricultural cooperatives, limited liability companies, etc.

Land Tenure 1990-1997 (percent of agricultural land)

¹ This share is, however, higher than the one registered a year ago – 20% or 205 thousand applicants in April 1997.

² *Privatization rate* is the ratio of the number of individuals who received a physical plot to the total number of individuals entitled to land shares in the district.

	1990	1991	1992	1993	1994	1995	1996	1997
State sector	32.3	26.7	25.2	31.2	30.1	16.7	17.3	17.7
State farms	27.0	23.4	20.4	14.6	12.8	0.1	1.0	1.0
Reserve fund	0.0	0.0	0.1	12.7	13.3	13.4	13.6	14.0
Corporate forms	59.4	63.0	63.0	56.2	56.8	67.9	64.8	61.4
Collectives	59.4	63.0	58.8	49.2	45.2	39.3	23.1	15.2
New corporate forms	0.0	0.0	4.2	6.2	8.9	27.6	38.9	43.0
Farmers associations	--	--	--	0.8	2.7	1.0	2.8	3.2
Individual sector	8.3	10.3	11.7	12.6	13.2	15.3	18.0	20.9
Peasant farms	--	--	0.0	0.3	0.7	2.4	4.8	7.8
Household plots	8.3	10.3	11.7	12.3	12.5	12.9	13.2	13.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: *Cadastral land balances* (end of year data)

The state farms have practically disappeared, as almost all of them transformed into collectives and received their land in ownership from the state, and in turn many collectives registered in new organizational forms. Thus, in 1997 state farms have controlled nearly 1% of agricultural land, collectives controlled 15% and the new corporate farms controlled 46% of the agricultural overall land.

The high fragmentation of land plots is an important structural change that occurred along with the process of division of land into small family farms, which are further subdivided into individual plots growing different crops. This phenomenon can have a negative impact on certain types of arable crop production, and besides, it leads to increased costs and inefficient mechanization, especially in the conditions of Moldova where small-scale machinery available for purchase is very limited. Encouraging consolidation of individual land plots in bigger areas under one crop would be welcomed and this can be done through land leasing and land market development.

The privatization of non-land assets takes place at a slower pace as compared to that of land assets. As of April 1, 1998, 53% of individuals entitled to property shares in large-scale farms, which are active and former rural workers, as well as pensioners, have received a certificate of ownership and about two thirds of these certificates have been registered by local authorities. The value of privatized assets accounts for 64% of the total assets earmarked for privatization. Up to now the distribution has the form of paper certificates and does not yet involve division of physical assets. The average value of an asset share in Moldova (after the 1996 revaluation of assets) is 5,300 lei, that by no means represents the real market value of assets, most of which are old, worn out and not of much use for production.

An important component of the asset privatization program is the transfer of responsibility for social assets and services to local authorities, which enables the large farms to concentrate on productive business-oriented activities. This process has not progressed quickly until now: only 19% of social assets have been transferred to local authorities as of April 1, 1998. However, when comparing all current data to those of last year, a slow but steady progress of the asset privatization process is clearly observed.

Farm Restructuring and Private Farm Development

There are around 1,000 large-scale farms in Moldova today, a number practically similar to that of collective and state farms prior to reform. Based on the number of members and the average land share in Moldova (1.5-2.0 ha), the land holdings of some new organizational forms, such as agricultural cooperatives and joint stock companies, can be estimated at 1,500-2,000 ha. Thus it seems that traditional forms reorganize into new ones without significant downsizing and fragmentation with a main difference that the new structures guarantee the right of their members to exit with land and assets.

Farmers associations and limited liability companies appear to be much smaller, with 100-200 members on average and apparently constitute a truly new intermediate form between the

traditional large-scale farms and small peasant farms. However, only 124 farmers associations, out of 244, are actually created by peasant farms and they combine about 13 thousand members, or 20% of the total number of registered private farms. The rest are, probably, traditional large-scale farm that did not go beyond "changing the sign on the door".

The privatized assets valued at over 3.5 billion lei have been transferred to the new organizational forms, representing over 1000 large scale structures and nearly 200,000 individual land holders, that have created independent farming units (not necessarily registered as private farms). The transfer of assets to large-scale organizations is almost completed: they have received on average 90% of assets represented by the entitlement shares of their members. The individual farmers, on the other hand, have received less than 70% of their asset entitlement from the parent farms.

Out of a total number of 198 thousand owners of land plots as of April 1, 1998, only 96 thousand have used them to create over 68 thousand private farms. Concomitantly, the number of individuals with no intention to register their farms continuously rises, which confirms the tendency of rural population to lease land while holding the ownership title. So, the rest 100 thousand people are involved in subsistence farming or have leased out their land plots to the leaders of larger farms, commercial firms, etc.

Land Holdings of Private Farms

	Jan. 97	April 1997	April 1998
Individuals who applied to receive land shares in physical form	168,178	204,771	277,970
Individuals allocated land in private ownership including	117,002	131,891	198,047
Individuals who did not register their land plots	42,982	61,747	102,095
Number of registered peasant farms	41,229	51,488	68,485

Source: Department of Statistical and Sociological Analysis

The Moldovan Government announced at a meeting for farm managers and mayors on March 14, 1998, that the Land Project is the National Program for privatization and reorganization of agricultural enterprises in the Republic of Moldova. The Ministry of Privatization and State Property Administration of the Republic of Moldova has been working with two contractors of the United States Agency for International Development, Booz-Allen & Hamilton and Center for Private Business Reform (CPBR) on completing this task.

The program is an extension of the pilot project that began in Nisporeni with "Maiak" farm enterprise in 1996 and continued in 1997 with 72 former state and collective farms being privatized and reorganized. By March 1998 over 70 thousand land titles have been issued and an impressive number of people received their land plots in kind. On the basis of experience acquired, about 100 specialists have been trained in Chişinău and in 10 territorial agencies. A manual "Methodology of the break-up of collective farms in Moldova" was prepared, adapted to Moldovan legislation and to local social and economic conditions, which includes recommendations for the transformation of collective farms and state farms into market-oriented farm units and associations.

The 1998-1999 National Program will comprise 550 agricultural enterprises interested in privatizing and reorganizing, resulting in the issuance of land title certificates and distribution of property to entitled individuals. By June 1998 68 large farms had been already broken up and dismantled, but titling has not been yet done. USAID Land Project is currently working with additional 100 farms. The physical allocation of land is scheduled for September 1998, and the provision of land titles is expected to occur in October 1998.

Financial Crisis in Agriculture

Since the start of reforms the agriculture has suffered the most from price liberalization. Being an inert branch that has strong links with the biological cycles of the nature, agriculture has lost financial means in the period 1991-1993 of high inflation. Later on the adjustment to new economic conditions has been impeded by the difference in prices for inputs and outputs. Unexpectedly enough, the sector considered the base of the economy has become unprofitable and unable to cover production costs. The attempts of the state to support the large scale unstructured enterprises by means of granting technical credits have not been effective.

During 6 years (1992-97) the agricultural enterprises have received about 360 million lei of state guaranteed credits from the Ministry of Finance, including technical credits for acquisition of petrol products, spare parts, mineral fertilizers, plant protection agents, and aimed at providing help to the agricultural producers and processors, given their scarce financial resources. However, over 50% of agricultural enterprises haven't paid back the credits in time due, and thus, a total amount of 141 million lei has not been returned. Moreover, an important share of credits granted (over 70 million lei) have been simply cancelled by the state, fact that transforms them into direct subsidies.

The main reasons explaining the lamentable financial situation of large-scale collective enterprises are the low productivity of labor, land and capital, as well as the weak reaction to changing market conditions.

As a result of their non-profitability, the agriculture enterprises do not pay taxes, thus accumulating huge debts and requiring state support that lies as a heavy burden on the state budget. The total tax collection rate in Moldova averaged at 80% in 1997: the tax collection from agri-processing industry exceeded the average (85%), while the agricultural sector registered the lowest tax collection rate in the economy – 48%³. Moreover, the share of agri-industrial sector in total budget arrears accounts for 60%, 48% of which belongs to agriculture. Meanwhile, the agricultural contributions to the budget revenue constitute only 14% of the total, which is half of sector's share in GDP.

However, there are significant differences within the agricultural sector in this respect. According to the results of a study on tax and subsidies⁴, peasant farms pay nearly 100% of their taxes, whereas large farms pay on average less than 35% of their tax liabilities. Moreover, the large agricultural enterprises make most of their tax payments in kind, partly voluntarily, and partly in the framework of government initiated campaigns (e.g. grain procurement). Meanwhile, peasant farmers pay the tax liabilities fully in cash.

The lamentable position of the agricultural enterprises, as well as the ineffectiveness of the current state subsidies is clearly observed when comparing two indicators: the negative profit reached by agricultural enterprises in 1996 – 240 million lei and the non-cash support of 430 million lei used as tax/debt reduction of economic agents to the state.

According to the consolidated balance sheet, the total obligations of the large farms at the end of 1997 were 2.2 billion lei. These are predominantly current obligations including accounts payable to: suppliers for inputs and services (800 million lei), salary arrears (190 million lei), budget and social fund (760 million lei, or over 34% of total obligations). Bank credits have a relatively small share of 10% of the total, including 108 million lei long-term credit and 116 million lei short-term credit.

A positive sign is that total current obligation of large scale farms slightly decreased in 1997 (coming down from 2.3 billion lei in 1996) due to a reduction in farms' obligations to the budget, social fund, as well as to commercial banks (Table 12, An1). This fact indicates that the state has tightened the tax collection system, while the responsibility of farms toward bank

³ Data of the Fiscal State Inspectorate of Moldova

⁴ The study on tax and subsidies system have been accomplished by ASA Institute for Sectoral Analysis (Germany) in collaboration with Agency for Restructuring Agriculture (ARA).

credits reimbursement has increased. However, the payment to employees and suppliers has worsened last year.

The total debt of agri-processing industry in amount of 0.5 billion lei appears much smaller as compared to the one of the primary agriculture.

As of January 1, 1998, the volume of farm sales, which is actually the source of earnings for repayment of debt, is very low in 1997 (as well as in 1996): only 2.5 billion lei as compared to total balance of 15 billion lei. Farms have nearly 1 billion lei in salable stocks of products and in account receivable versus current obligations of 1.8 billion lei, fact, which indicates a low level of working capital.

The Law on Budget for 1998, adopted on December 27, 1997, makes important stipulations regarding debt postponing of agricultural enterprises. The immediate impact of the above law stipulations has been negative on the state budget, as agricultural enterprises chose the 'wait and see' strategy and stopped paying even current taxes to the state and local budgets. According to the data of the State Inspectorate as of 1.06.98, the tax collection rate of enterprises pertaining to the agri-sector to the state and local budgets was about 10% and constituted only 3.8% of 1998 state revenues.

* * *

Real privatization and farm restructuring is the most recommended way to improve tax collection and, thus, raise government revenues. By increasing the share of peasant and real private farming, which tend to be both more productive and better tax-compliant, the government revenues would significantly grow. Besides, the functioning of the tax system is going to be improved as soon as the payments in kind are eliminated and the vicious circle of arrears and debt write-offs is avoided.

The farm restructuring process has to be continued according to the patterns developed in Moldova. The National Farm Restructuring Program envisages complete restructuring of at least 50% of large-scale agricultural enterprises by the end of 1999. While implementing the Program the methodology developed under the pilot projects has to be used without deviations, thus ensuring genuine reorganization based on market-oriented operation and incentive systems that encourage individual accountability. Settlement of outstanding debts must be concluded under the condition of general restructuring. Strict financial discipline must be enforced in all farming units that are currently unable to operate efficiently. The application of bankruptcy procedure, which is currently being implemented by the Ministry of Finance and ARA, will hopefully bring positive results in the nearest future.

At the present moment the farm restructuring process is seriously constrained and slowed down by the absence of a consistent legal framework (contradictions between the Law on Privatization and law on Bankruptcy), as well as lack of clear political decisions concerning expedited settlement of debt of those farms which are ready to be restructured. Thus, the further targets on farm restructuring are likely to be met *only if* a new legislative framework backed by strong political will toward the expedited settlements of farm debts is adopted.

3.4 Privatization and private sector development

According to the Constitution of the Republic of Moldova, the development of a viable private sector is a priority for the national economy. Since the beginning of the 90s, three privatization programs were adopted and implemented, the first one - for Patrimonial Bonds - in 1994, the second - mixed privatization for Bonds and cash - in 1995 and 1996, and, finally, privatization for cash exclusively in 1997. Nevertheless, the process of private sector

development in the Republic of Moldova confronted many formal and informal obstacles, no less than 50 per cent of it being embraced by the shadow economy.

Causes for delays in privatization have been multiple:

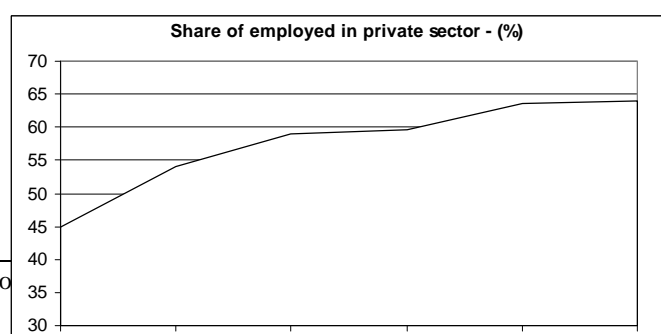
- inconsistent policies with regard to the sale of unfinished constructions and other underdeveloped projects (oftentimes significantly overpriced);
- lack of property rights protection due to a weakly developed legal system;
- lack of interest in a truly popular privatization on the part of those who benefited from illegal grabs of state property;
- inconsistencies in terms of payment with the nature of expenditures, which represent an investment for the buyers (50 per cent at the moment of signing of the contract and 50 per cent three months later, both – in cash);
- nonpayment of rent by the companies to the local budgets and, as a result, the refusal of local administrations to allow their sale;
- small enterprises interest for privatization the adjacent lends for investments, and lack of interest in purchasing it for medium and big enterprises.

The mass privatization process created a bisectoral economy, a new class of owners has been established, conditions were created conditions for the development of stock and capital markets, and corporate management practices were improved.

Current situation. During 1997 and the first half of 1998, the privatization occurred in unsatisfactory pace. From 2000 of rented premises only 283 were sold to small enterprises, which had a negative impact on investments. From 1,900 of adjacent plots only 26 in Chişinău and 17 in Bălţi were sold. From 724 joint stock companies for sale only 276 were sold at a nominal price of lei 18.6 million and a market price – lei 7.5 million. The privatization of enterprises attractive for foreign investors in which the state holds the control stock of shares is taking place slowly. A series of attempts by the Ministry of Privatization to sell the control stock of shares by means of international and local tenders were not successful, due to the excessively high prices established and accumulated debts. The decision making process was delayed in a couple of cases when there existed a demand from foreign agents (“Tutun”, “Ciment”). None of the strategic enterprises (from the energy sector, “Moldotelecom”, a couple of wine factories, former military complex etc.) were sold.

According to the Ministry of Privatization in 1996-1997, 90 state property auctions were organized, in which offered were a total of 636 objects. 120 of these were sold for a total price of lei 34.5m. The trade in shares of state enterprises remained after sales for Patrimonial Bons began on the local stock market. Offered for sale were the shares of all enterprises, which possessed unsolicited stocks, at the nominal value of lei 471.6m. At the fifteen bidding sessions held, stocks worth of lei 6.9m were sold. About 10,000 apartments have been privatized, revenues amounting to lei 5.5m. Sixteen auctions of unfinished industrial projects were organized, in which out of 56 offered for sale only 8 were sold for a total of lei 1.2m. The first stage of reorganization of the energy sector has been completed. The formulation of the procedure of privatization of these individual corporations has begun, subject to the approval by the Parliament. The Ministry of Privatization started the implementation of the program “Pământ” (‘Land’) for the reorganization and privatization in the agricultural sector. In 72 agricultural enterprises in some 15 counties these activities are in the final stage.

In the first quarter of 1998, state property worth of lei 31.53m was privatized, compared to lei 15.45m in the corresponding period of 1997. There were 39 state property auctions, at which out of 365 objects offered 38 were sold only. Despite this fact, it is expected that the total value of public property sold in 1998 will reach lei 200m.



Problems and consequences of privatization in Moldova. The first and most important consequence of privatization for Patrimonial Bons is: *the productivity of enterprises privatized for Patrimonial Bons did not grow*, the share of population employed in the private sector is 64 per cent, the share of private sector in GDP is about 60 per cent. Therefore, the productivity of the private sector is even smaller than that of the state sector. This is due to multiple reasons: a relatively easier concealment of incomes in private sector in comparison with the state sector, lack of an efficient corporate management system, and inefficiency of privatization for Patrimonial Bons.

Pluses and minuses of various forms of privatization					
	Better corporate governance	Speed and feasibility	Better access to capital, skills	More government revenue	Greater fairness
Sale to outside owners	+	-	+	+	-
Management-employee buyout	-	+	-	-	-
Equal-access voucher privatization	?	+	?	-	+
Spontaneous privatization	?	?	-	-	-

Source: From plan to market: World Development Report 1996

The privatization for Patrimonial Bons should have been done as soon as possible for the transition to the privatization for money. Delaying the privatization caused a number of problems:

- *lack of a real owner, dispersion of state property amongst a very large number of proprietors unable to ensure adequate level of investment for the re-modernization of privatized enterprises;*
- *low capacity of the state to exercise control over its property, inadequate involvement of government officials and even disinterest and lack of political will in privatization-related decision-making;*
- *in the course of privatization, a great deal of capital equipment was illegally removed from enterprises, which blocked their timely privatization;*
- *lack of a corporate management system, abuse of power, and lack of responsibility on the part of the managers;*
- *delays in the adoption of the State Program for supporting the small business for 1998 – 2000 and the Law of Entrepreneurial License impedes brakes the development of private sector;*
- *registration of various types of property (land, buildings, etc.) is administered by different Government agencies - a disharmonizing practice that does not appeal to potential investors;*
- *a weak system of state control authorities and inadequate legislative basis that contribute to sliding of private business into the informal sector, which, in turn, results in difficulties in obtaining reliable economic statistics and effecting a meaningful analysis of the economy.*

Objectives for expanding the private sector include: consolidation of legal and institutional framework for private property, extending the list of enterprises subject to privatization and diversifying the forms of their privatization, establishment of an efficient corporate management system, consolidation of share holdings, development of the real estate market, finalization of housing stock privatization, acceleration of reforms in the agrarian sector.

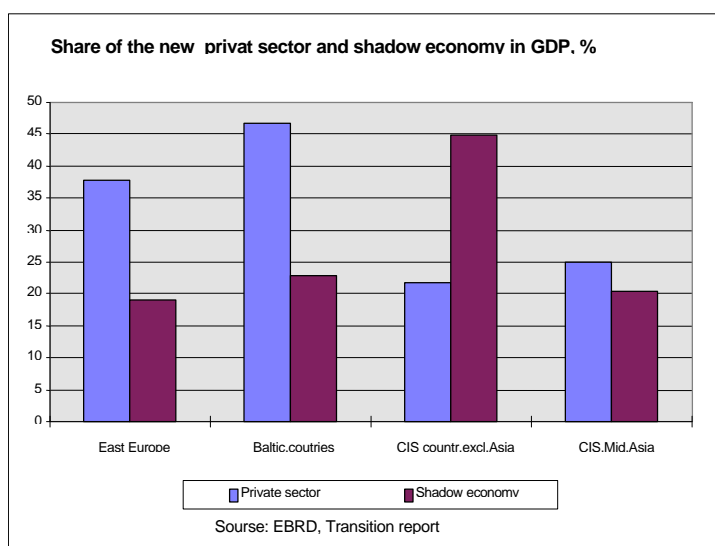
Actions aimed at private sector development include:

- Selling the supplementary rented entities of small scale (500 more enterprises), the adjacent lands (about 470 parcels);
- Improvement of the terms of payment for privatized premises – 25 per cent – to be paid immediately upon the signing of the contract and 75 per cent over three years;
- Taking effective measures toward making the privatized enterprises pay rent for the land to local administrations instead of paying taxes for land, as it is now;
- Converting the deposits in the savings banks in shares remained after privatization; launching privatization through repayment of the state debts with assets or shares of the enterprises subjected to privatization;
- Launch of privatization of energy and telecommunications sectors involving foreign investment in these sectors; privatization of tobacco factories, wineries located in the Russian Federation, as well as electronics manufacturing industry;
- Acceleration of privatization of agricultural enterprises, promotion of farmers' associations and allotment of land plots according to the National Program "Pământ";
- Ensuring the continuation of housing stock privatization and promotion of private housing owners' associations;
- Supporting greater involvement of Moldovan citizenry in the domestic stock market through measures such as Public Offers;
- Establishment of an integrated system of registration of various types of property;
- Effecting inventories of unfinished enterprises subject to privatization for their further sale for a symbolic price;
- Compilation of a unified information database of public property to ensure its privatization in conformity with the state program;
- Amending the existing legislation with the view to facilitate sale/purchase of state property;
- Allocation of at least half of the revenues from privatization of public property to restructuring and further modernization of privatized enterprises;
- Improving administration of state-owned property, including those with 100% state capital and those of mixed ownership managed by private partners; establishment of a State Property Fund endowed with legal personality.

Thus, by the year 2000, property reform should bring the share of private sector in Moldova's GDP up to 60% to 65%.

However, the economic situation of the private sector remains unclear. An economic data-base is absent. It is impossible to evaluate objectively the productivity of functioning of this sector.

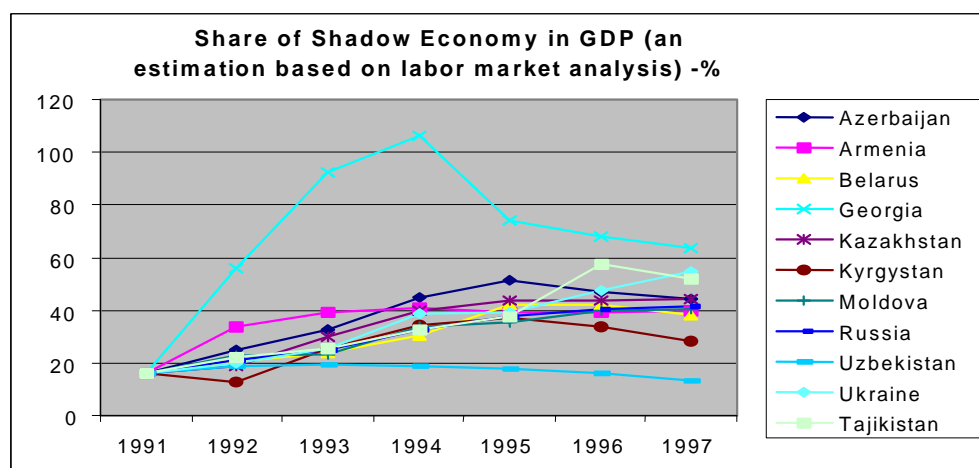
A common characteristic for the post-socialist countries is sliding of the private sector as well as the state one into the shadow economy. In the Transition Report -1997 of EBRD it is mentioned, that if in countries of Eastern Europe and Baltic states the private sector share prevails, in NIS the share of the underground sector predominates, which includes in big part a unreported production of the private sector.



3.5 Shadow economy

The shadow economy in transition countries, especially in NIS, differs to some extent from shadow economies in developed countries. This is manifested in the fact that the state sector is very active in realizing shadow economic transactions, often the state property is used for obtaining unofficial personal gains by the state employees. A clear divide between the official and nonofficial sectors is absent, the labor force of the underground sector includes high skilled professionals. The shadow economy in NIS countries grew up so substantially not only because of the economic decline, but also as a result of involving in the privatization process of new objects – land, assets of enterprises, etc.

It is possible that the shadow economy phenomenon has an anti-cyclic character and grows up, even faster in countries experiencing economic decline. Methods of estimation of the shadow economy's volume of output are bound to be not fully accurate and give a very approximate picture of the real situation. Moreover, the results will differ depending on the method used. Therefore, for making an international analysis of the degree of presence of this phenomenon, it is necessary to use the same methods of estimation and to take averages for every country. In this study a labor force market analysis on the information on NIS countries was used. The specific of the method lie in underestimation of shadow economy parameters. Thus, utilization of monetary methods would produce far graver results. Furthermore, the utilization of the same method for the Republic of Moldova on the basis of the scriptic number of employees instead of employed population leads to a 7-8 per cent increase in the results.



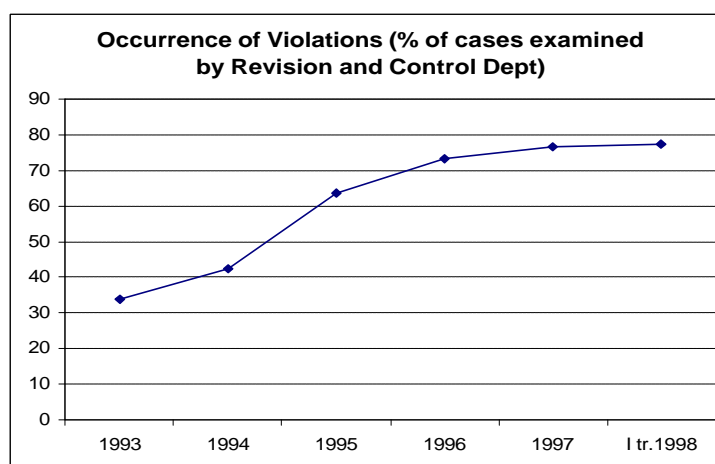
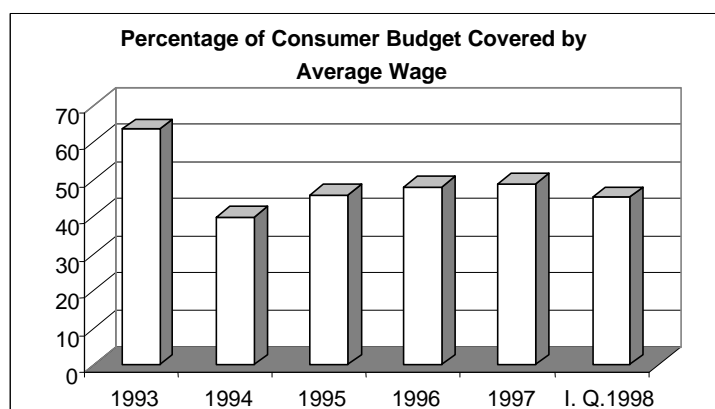
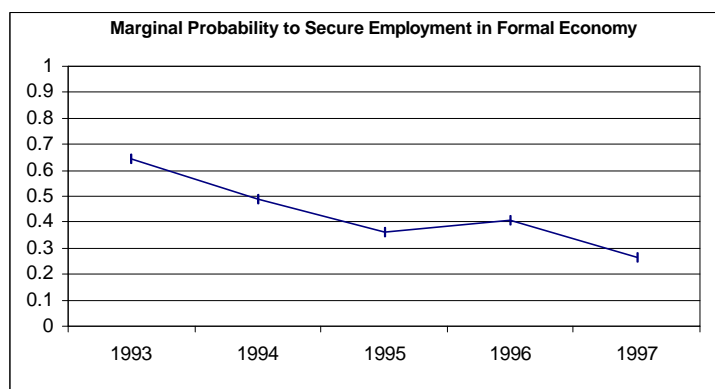
Starting with 1994-1995 the share of the shadow economy began to diminish in a number of countries. This can be explained not as much by some essential regulating measures made by the state, as due to the launch of the stabilization process in those countries resulting in diminished share of the shadow economy in the official one. A case in point is Georgia. During 1991 – 1994, the number of employed diminished from 2.5 to 1.75 million persons (by 30 per cent), growing up to 2.1 million persons in 1997.

For the Republic of Moldova the, 1997 economic relaunch (GDP growth by 1.3 per cent) was too small, therefore the rate of the shadow economy in comparison to the official one is in continuing growth. The discrepancy between unemployment and vacancies grows up and, as result, the marginal probability to find a job in the formal sector of the economy grows up.

The situation of the employed in the formal sector is discouraging too. The registered revenues of less than 3 per cent of population (5 per cent of urban population and 1.9 per cent of the rural one) cover the consumer basket. The share of the average wage in the consumer basket (40 per cent) remains still too small for a long run to allow the population to survive, staying only in the formal sector of the economy. This “pushes” a growing share of population to the shadow sector.

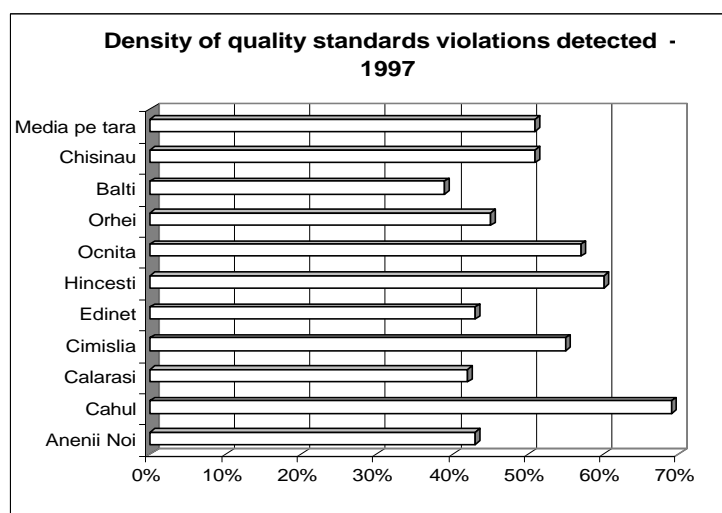
The spread of the phenomenon of shadow economy is accompanied by the growth in crime, fall of economic and financial discipline, quality of goods and services. Thus, during the first quarter of 1998, the number of crimes, including the economic ones, grew up by 5.3 per cent in comparison to the last year. According to some estimates, the daily income of the drug-business in Bălți amounts to about 2 million lei. Losses of power grew up from 10 per cent of the total consumption in 1990 to more than 30 per cent in 1997, constituting daily 300 thousand lei, according to some evaluations.

The growth of illegal export-import transactions' volume is worrisome. Thus, according to Romanian data (“Curierul Național”) the volume of Moldovan sugar exports to Romania exceeded by 1.8 times (450 Th. tons) the officially recorded volume of production of sugar on the territory of the Republic Moldova. Generally, a big part of this sugar is produced in the Ukraine, and is fraudulently certified as originated from Moldova, with the aim of gaining advantages from the trade agreement between Romania and Moldova. The comparison between Russian and



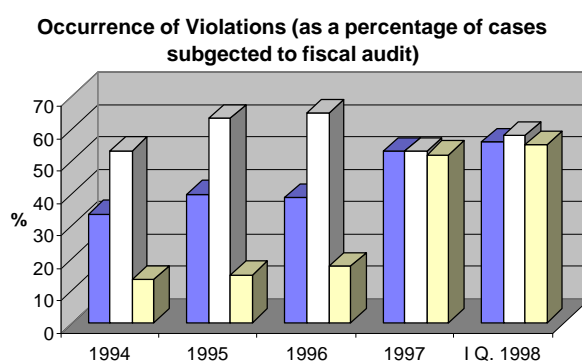
Moldovan official statistics sources indicates that the sparkling wine exports of Moldova exceed 1.6 times the Moldovan production; more than this, after passing the border prices grow up 2.4 times. In the Russian statistics the imports of Vermut – wine from Hungary and Bulgaria disappeared – since, as they pass the customs, they are being registered as Moldovan wines, thus giving the violators the advantages of the Moldo-Russian agreement. A practical absence of a border between the right side of Moldova and the territory of Transnistria and the existence of two different fiscal systems on this territory implies considerable losses to the state budget of Moldova. Thus, the absence of a value added tax on the territory of Transnistria implies paying the custom duties on the territory of Transnistria, coming to the right side of r. Nistru as local goods, avoiding paying the VAT (in average 20 per cent), aggravating the situation in the budget and creating an *unhealthy competition to the local goods*.

Production and marketing of fake or uncertified goods is a component of the shadow economy. It has a double negative impact: on health of population and worsening of Moldova's prestige in the external market. The *Department for Standards, Metrology and Supervision of Moldova*, having as its most important direction the protection of consumers rights through state control and supervision of normative documents, firstly, referring to the populations health and life security, the environment protection and growth of goods and services quality, made a number of controls in 1997. The results of the department's work indicated, that during 2,226 checks made 1,129 violations were detected (51 per cent - in 1997 and 47 per cent in 1996). The share of deviations from required standards amounted 61 per cent (in 1996 – 48 per cent). A regional goods and services quality differences is observed. On average, there are established violations (deviations of quality standards, faking, or absence of necessary documentation) for meat – foods in about 52 per cent, for canned vegetables and fruits – in 77 per cent of cases, alcoholic beverages – 39 per cent, electric appliances – 67 per cent, for the commodities for children, the deviation rate reached 74 per cent, services -63 per cent.



A worrying sign is the quality of imported goods. The Republic of Moldova, being a small open economy, promotes a policy of liberalization of external trade. In many cases, the imported goods create a serious competition for the local ones often easily substituting them, and discouraging the local production. Having competitive prices, these goods often are of bad quality and are harmful for population's health. Thus the density of negative results for imported goods is bigger than the average in the country and reached 79 per cent in 1997 against 86 per cent in 1996. In the case of detection of this cases of law violation, the aforementioned Department prohibits the trade of these goods. The mass information of the population regarding the quality of goods, including the imported ones could offer to consumer the possibility of choosing between price and quality, and, possibly, could contribute to the reviving of local production.

Placing emphasis on the quality of goods is an obligatory condition for a stable economic development and the

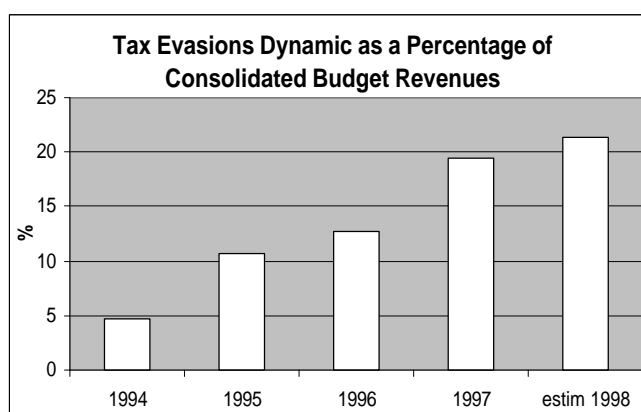


country's prestige. With the aim of consolidation of the country's relation with other countries and collaboration with different international organizations, according to the decision of the General ISO (International Standards Organization) Assembly, the Republic of Moldova represented by the Department for Standards, Metrology and Supervision became a correspondent member of ISO in 1997. Agreements of collaboration in the field of standardization with Lithuania, the Ukraine, Azerbaijan, Uzbekistan were signed. The preparation for the entrance of the Republic of Moldova into the WTO was completed. For the Republic of Moldova, it is important that these kinds of agreements be signed with the basic partners in export-import transactions.

Year 1997 and the first quarter of 1998 were marked by a decline in the economic and financial discipline. The data of the Department for Revision and Control show that the density of violations in the total number of control continues to grow, the prejudice per economic unity grew up from 3.3 thousand lei in 1997 till 6.9 thousand lei in the first quarter of 1998, almost doubled. According to our estimation, in 1998 it is expected the total prejudice to reach about lei 90 millions in 1998. According to the information of the *Main State Fiscal Inspection*, in 1997, 17,541 (I quarter 1998 – 4614) units from 219,180 (respectively, 234,025) were exposed to fiscal control, in 9,233 (I quarter 1998 – 2,601) cases violations were detected. Additional payments were calculated in the volume of lei 290.3 million (in I quarter 1998 – 44.8), including fines lei 163.7 (22.5) million. In the course of the analyzed period, a practical leveling in the density of violations among legal entities and individuals took place.

The evaluation of the proportions of tax evasion in the Republic of Moldova in 1997 – I quarter of 1998 was done on the basis of the information contained in “The Report regarding the results of control activity of the respecting the legislation and other payments” of the Main State Fiscal Inspection, depending on the share of checked taxpayers and the detected sum of evasions (see following tables). The calculations showed a slow down of the tax evasion process in the first quarter 1998. In the structure of tax evasion, LTDs, stock companies and cooperatives of all kinds predominate.

The compensation of losses detected by the inspectors of the Main State Fiscal Inspection occurs in very slow pace. Thus, while in 1996 there was collected 19.09 per cent of the established sum, in 1997 – only 13.7%, and in the first quarter 1998 - 15.6%.



Evaluation of tax evasion in the Republic of Moldova - 1997 (Th. lei)

	Total	Subjected to audits	Density of control	Violation detected	Density of violation	Suppliment. payments	Detected evasions	Average evasion	Benefit from evasion	Efficacy of evasion	Fines	Collected total	Collected %	Collected fines	Collected fines %	Total Evasions
Total legal entities and individuals	219190	17541	0.08	5233	0.53	290300.9	129531.3	7.22	103398.4864	445.05	163669.6	39909.7	13.75	23213.6	0.14	537408
Legal entities - total	173801	11524	0.07	6095	0.53	280576.1	121930.6	10.59	103386.8004	565.73	156695.5	38547.4	13.74	22418.4	0.14	502394
including:																
state enterprises	1407	773	0.55	659	0.72	32856.8	15885.1	20.39	-2365.74	-13.11	17170.7	8124.7	24.73	4378.2	0.25	28550
joint enterprises	38	10	0.26	9	0.90	486.5	248.8	24.88	126.04	102.67	217.7	33.8	7.20	26.3	0.12	945
renting enterprises	64	16	0.25	10	0.63	129.9	77.2	4.83	46.23	149.23	46.7	13.8	11.14	8.8	0.19	309
cooperatives of all kinds	3109	1012	0.33	839	0.83	49546.8	23541.7	23.36	8783.69	58.12	22004.1	5613.4	12.30	3604.9	0.17	72630
from them kolshozas	367	317	0.86	274	0.86	29226.6	15277.3	48.19	-9967.47	-39.48	13949.3	3955.9	13.57	2543.6	0.19	17687
LTDs	21869	3618	0.17	2323	0.64	66720.6	30721.3	8.49	19883.07	178.32	38999.3	6445.2	9.66	4049.5	0.11	158895
stock companies	4886	1816	0.37	1408	0.78	84221	33329.1	18.36	2066.37	6.68	50691.9	11640.7	13.82	6509.5	0.13	89759
enterprises with foreign invest.	1298	183	0.14	140	0.77	9794.5	5891.7	31.67	4450.81	322.31	3962.8	992.4	10.13	613.3	0.15	41364
social organizations	3387	313	0.09	146	0.47	2769.3	1719.9	5.49	1463.98	572.05	1049.4	202.8	7.32	95.2	0.09	18611
banks	29	11	0.38	9	0.82	5992.3	2547.9	240.72	374.96	16.60	3344.4	4754.8	79.35	2578.1	0.77	6991
insurance companies	103	13	0.13	6	0.46	161.4	62.8	4.83	42.43	208.28	98.6	31.6	19.58	24.6	0.25	498
associations, concerns	473	111	0.23	80	0.73	23076.8	3765.2	34.10	-1630.29	-30.10	19291.6	296.6	1.29	113.9	0.01	16130
other unions																
farmers	133606	2577	0.02	41	0.02	194.7	61.4	0.02	57.64	1534.99	133.3	37.9	19.47	16.2	0.11	3183
budget institutions	2316	827	0.36	366	0.47	1203.2	302.8	0.37	-126.84	-28.62	900.4	295.6	24.58	186.1	0.21	846
other legal entities	1214	245	0.20	129	0.53	7350.3	3875.7	15.82	2392.32	161.27	3474.6	64.1	0.87	14.8	0.00	19204
Individuals - total	45379	6017	0.13	3148	0.52	9724.8	9540.7	0.771265	3351.245253	259.6966	5084.1	1352.3	14.0061	785.2	0.158409	39014
individual enterprises	45194	6006	0.13	3128	0.52	9681.7	9520.6	0.77	3336.32	269.78	5061.1	1376.2	14.24	787.6	0.16	34833
collective societies	146	15	0.10	14	0.93	32.1	17.4	1.16	14.15	434.83	14.7	11.5	35.83	7.6	0.52	172
societ with unlim. responsib.	37	7	0.19	6	0.86	11	1.7	0.24	-0.39	-18.31	9.3	0	0.00	0	0.00	9

Estimation of tax evasion in the Republic of moldova - first quarter 1998 (Th. Lei)

	Total	Subjected to audits	Density of control	Violation detected	Density of violation	Suppliment. payments	Detected evasions	Average evasion	Benefit from evasion	Efficacy of evasion	Fines	Collected total	Collected %	Collected fines	Collected fines %	Total Evasions
Total legal entities and individuals	234025	4514	0.02	2601	0.56	44879.00	22385.50	4.85	21809.05	616.20	22493.60	6952.6	15.51	4523.00	20.11	365373.67
Legal entities - total	185770	2184	0.01	1267	0.68	43613.90	21803.70	9.98	21290.95	1038.09	21810.20	6708.1	15.38	4345.20	19.92	354048.07
including:																
state enterprises	1403	150	0.11	98	0.65	4209.70	2378.60	15.86	1928.53	107.12	1831.10	1321.5	31.39	1126.70	61.53	22247.84
joint enterprises	97	3	0.03	3	1.00	28.70	6.70	2.23	5.81	163.70	22.00	0	0.00	0.00	0.00	216.63
renting enterprises	63	4	0.06	1	0.10	123.90	123.60	30.95	115.93	368.43	0.10	0	0.00	0.00	0.00	1949.85
cooperatives of all kinds	3130	238	0.08	160	0.67	4158.40	1765.40	7.42	1449.20	114.59	2393.00	667.6	16.05	495.00	20.69	23217.24
from them kolshozas	313	63	0.20	50	0.79	2864.40	1128.40	17.91	551.85	23.93	1736.00	73.2	2.56	52.40	3.02	5606.18
LTDs	22486	871	0.04	546	0.63	10403.90	6109.60	5.87	4706.60	291.97	6294.30	1313	12.62	784.60	14.82	131910.98
stock companies	4904	406	0.08	287	0.71	23953.70	12047.40	29.67	10072.66	127.61	11806.30	3118.9	13.06	1771.60	15.01	145518.35
enterprises with foreign invest.	1372	32	0.02	22	0.69	556.70	268.10	8.38	255.12	491.20	268.60	167.5	30.09	106.80	36.94	11494.79
social organizations	3692	23	0.01	9	0.39	32.10	27.50	1.20	27.30	3403.65	4.60	11.9	37.07	6.90	150.00	4402.39
banks	37	2	0.05	1	0.50	62.40	0.50	0.25	3.87	-28.71	62.90	7.7	-12.34	7.70	-12.24	9.25
insurance companies	94	1	0.01	1	1.00	0.40	0.20	0.20	0.20	1150.00	0.20	2.9	725.00	2.70	1350.00	18.80
associations, concerns	478	26	0.05	19	0.76	54.40	17.10	0.88	14.25	125.25	37.30	38.9	71.51	19.20	51.47	326.95
other unions																
farmers	144460	234	0.00	27	0.12	2.80	1.90	0.01	1.90	10447.91	0.90	3.7	132.14	3.70	411.11	1172.97
budget institutions	2283	162	0.08	84	0.45	280.60	137.80	0.75	115.43	129.01	142.80	295.8	53.20	186.10	130.32	1728.56
other legal entities	1281	13	0.01	9	0.69	94.80	42.90	3.30	41.94	1089.79	51.90	1.3	1.37	3.90	7.51	4227.30
Individuals - total	48255	2430	0.05	1334	0.65	1265.10	591.80	0.24	618.00	203.31	683.30	254.5	20.12	177.80	26.02	11325.60
individual enterprises	47211	2419	0.05	1328	0.65	1250.10	572.40	0.24	608.35	198.41	677.70	252.8	20.22	176.20	26.00	11171.38
collective societies	150	9	0.06	6	0.67	10.80	7.30	0.81	6.65	266.64	3.60	1.5	13.89	1.50	42.66	121.67
societ with unlim. responsib.	31	2	0.06	2	1.00	4.20	2.10	1.05	1.83	168.75	2.10	0.2	4.76	0.10	4.76	32.55

Fight against tax evasion as a way to ameliorate the budget deficit problem.

At present, one of the main state problems is the budget deficit. The study of traditional macroeconomic theories regarding budget deficit allows us to make a conclusion. Budget deficit implies shrinking of savings and investments, diminishing of capital stocks, which, in its turn, slows down economic development. In the long run this implies a rapid growth of the external debt, and current account balance deficit. According to these theories the state debt presents an additional burden for next generations, but for the Republic of Moldova – even for the current generation.

According to the Ricardian macroeconomic theory (less traditional), the state budget deficit is just a substitution of current debts by future growing taxes. The adherents of this theory consider the negative effects of the budget deficit on the country's economic development would not be essential. With regard to the Republic of Moldova, it is clear that the socio-economic condition will not allow the population to make these savings. Therefore the conclusions of the Ricardian theory will not be valid in the case of Moldova.

It is clear that the amelioration of this situation becomes more difficult and it is necessary to elaborate concrete measures. Amongst the most traditional ways of amelioration in this situation at least five could be used:

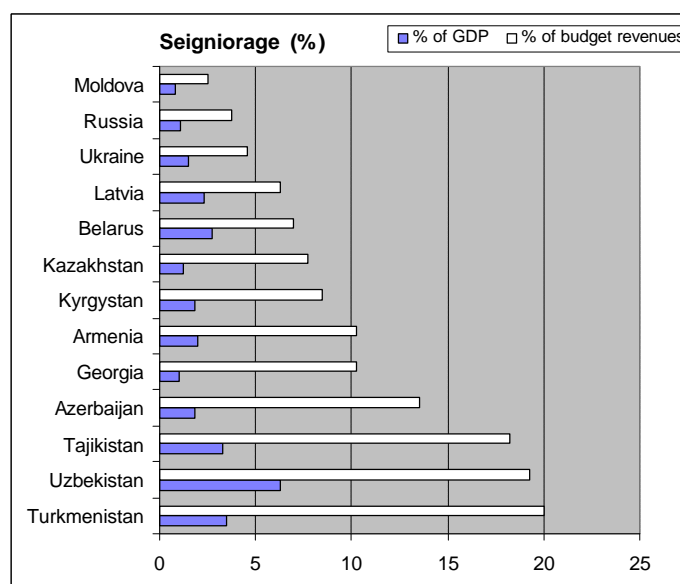
- financing the budget deficit out of supplementary credits;
- seignorage, or gains from money emission;
- tax growth;
- reduction of state expenditure;
- fight against tax evasion.

Unfortunately, the first way, that one of *financing the budget deficit out of supplementary credits* was overutilised during the last years, and as a result the external debt of the country grew up to 64 per cent of GDP in 1997. The continuation of this practice could be too dangerous for the economic stability of the country.

The seignorage or gaining revenues from the emission of additional sums of money is also problematic. The data of the National Bank of Moldova show that since the introduction the national currency, the money aggregate MO grew up more than 8 times achieving a sum of 972.06 million lei at the end of 1997. The “pressing” of this process could cause an inflation growth with all negative consciences.

Obtaining a growth in the budget revenues *raising taxes* will be doubtful too. First, our calculations show that the increase of the fiscal burden by one per cent will result in a 2-3 per cent growth of tax evasion. Secondly, the traditional macroeconomic models show that this will shrink the production and GDP. That is why this measure could be unacceptable for the condition of Moldova.

The reduction of the Government expenditure can be partially used in the short run to ameliorate the budget deficit problem, but it is a difficult way, from both social considerations and economic ones. The traditional macroeconomic models show that the diminishing of Government expenditures will cause the fall of GDP, or this measure could solve the problem



for a short time, but could be discouraging the economic growth.

Another way of solving the problem is *the fight against tax evasion*. Being prevalent in the society, the phenomenon of tax evasion presents a considerable reserve, a potential source of additional incomes for the budget. For a country like the Republic of Moldova a partial *fighting against tax evasion could be the most efficient way of solving the budget deficit problem, but the diminishing of the tax evasion in bigger proportions could create possibilities to ease the tax burden and stimulate the production.*

Among the causes of tax evasion phenomenon, a heavy and nonuniform tax burden, weakness of control institutions, and the existence of an overdriven system of fiscal facilities could be mentioned.

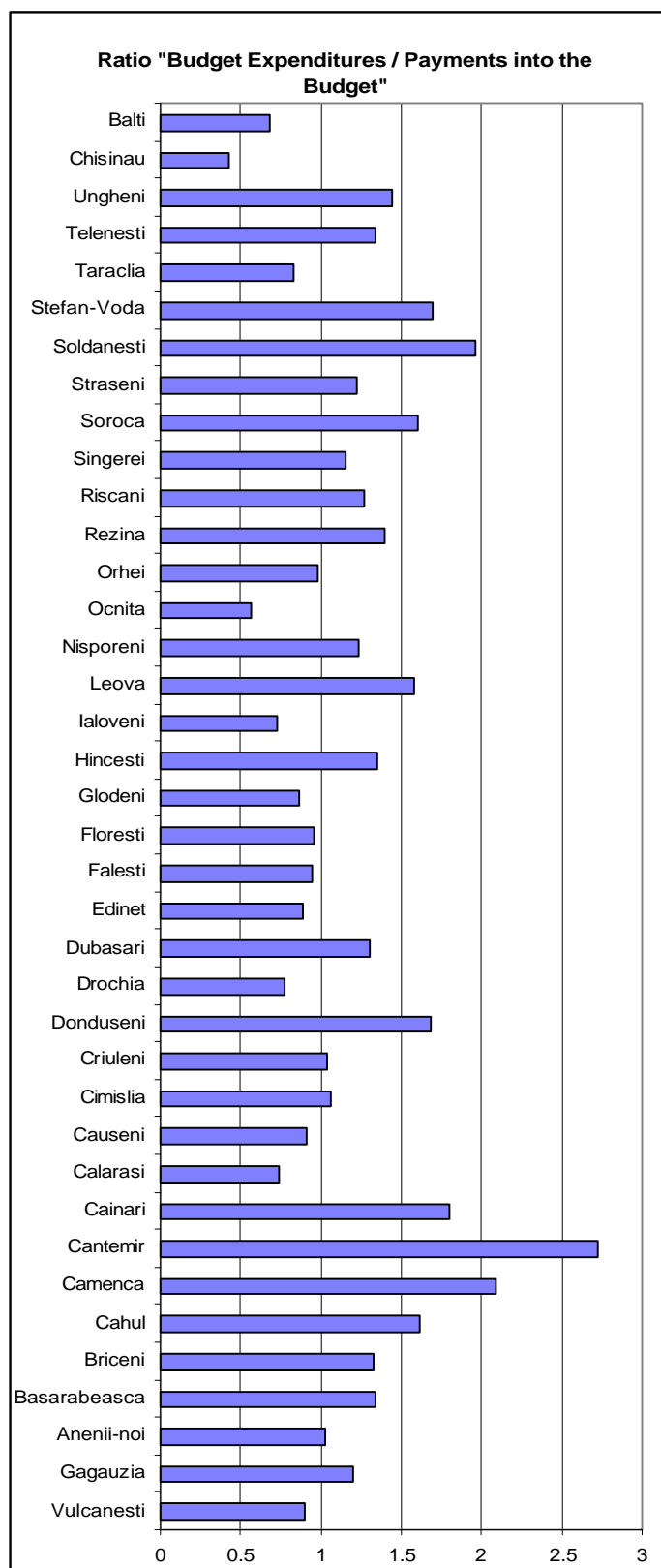
Even if the formal tax burden in the Republic of Moldova fluctuates during the last years in limits of 3—33 per cent, this figure is formed due to the fact that the tax burden for one part of economic agents exceeds 50 per cent, but the other part does not pay taxes.

Probably, one of the causes of tax evasion's phenomenon spread is lack of interest of the local authorities in fighting it. The ratio "budget expenditures / payments into the budget" varies substantially from one locality to another other (from 0.43 in Chi°inãu till 2.72 in Cantemir county). On one hand, the possibility to cover the local needs with finances from the state budget does not stimulate local administration to maximize tax collection. On the other hand, the realization by the local authorities of the fact that a big share of tax collection on the territory will be spent in other regions creates indifference to tax collection and facilitates other kind of agreements between local authorities and taxpayers.

Another cause of tax evasion spread is the weak activity of fiscal institutions. Thus, the share of economic agents subjected to fiscal

audits diminished from 32.3 per cent in 1994 to 8 per cent in 1997, and 1.9 per cent in the first quarter of 1998, which facilitates evasions.

In this study a basic *model of tax evasion* was examined. The following assumptions lie at the base of the model: the taxpayer is an amoral person and evades paying taxes when this is

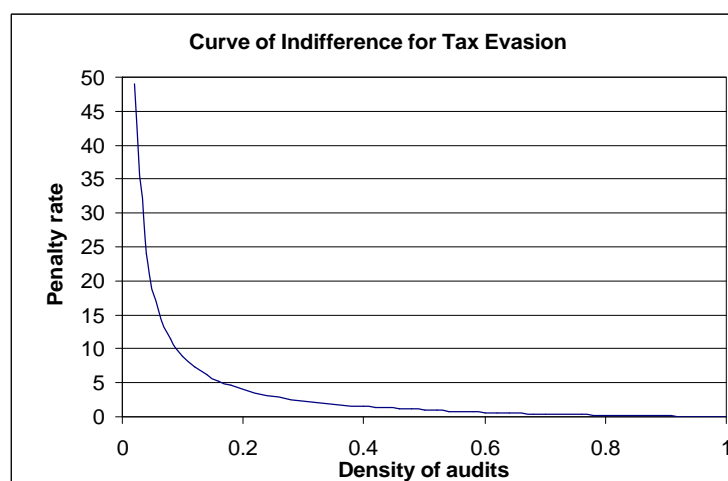
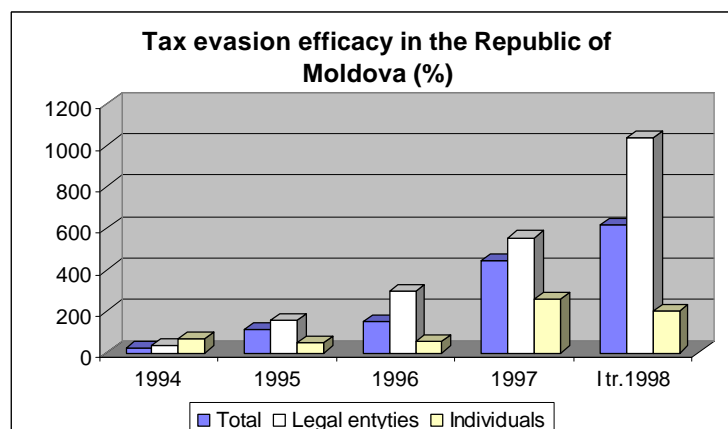


economically advantageous; the tax inspector is an absolutely honest person who objectively records all the violations of the fiscal legislation in his reports; the inflation rate is zero. The condition when tax evasion is considered to be economically advantageous means that the gain from tax evasion exceeds the expected losses in the case of detection by the fiscal auditors. In this case the gain from tax evasion is the tax evasion sum itself. The expected losses from tax evasion are the sum of tax evasion which will need to be reimbursed and penalty (fine) in the case of being caught corrected to the probability of being caught in tax evasion. The total net benefit from tax evasion was calculated being equal to the difference between the gains and expected losses.

The calculation made by the Main State Fiscal Inspection showed that for the majority of the taxpayers' categories the benefit from tax evasion is positive, which means that there exist favorable conditions for tax evasion and the phenomenon will grow. In 1997, only state enterprises, budget institutions and kolkhozes were exceptions. The net benefit for legal entities amounted lei 103.5 million in 1997 and lei 21.2 million in the first quarter 1998. The net benefit of individuals - lei 3.4 million in 1997, lei 0.6 million in the first quarter 1998, and the total for the Republic of Moldova estimated at lei 107 million in 1997 and lei 22 million in the first quarter 1998.

For the numerical evaluation of the degree of tax evasion advantage a notion of "tax evasion efficiency" was defined as a ratio of the net benefit to expected losses. The calculation showed that this indicator grew up extremely fast during the last years and reached in 1998 a level of 1000 per cent for legal entities.

To fight this phenomenon, it is necessary to create the conditions that would reduce the economic efficacy of tax evasion to zero and would make the taxpayers indifferent to tax evasions. These conditions could be created by manipulating with the penalty rate and the probability of being caught in tax evasions (density of controls). The calculations allowed to obtain the *curve of indifference to tax evasions*. It presents the multitude of combinations between the penalty rate and the density of fiscal controls, which discourages the tax evasion, for which the efficacy of tax evasion is equal to zero.



We can see that the sensibility of these indicators is very strong. The surface under the indifference curve presents the multitude of combinations of penalty rates and densities of controls for which the tax evasion is efficient (the efficacy is positive). For the reduction of the phenomenon of tax evasion, the choice of the kind of control regime is important. The calculation showed that the efficacy of tax evasion does not depend on their volume. In space the dependence between penalty rate, density of controls and the efficacy of tax evasions forms a hyperboloid. The multitude of combinations under the zero level describes control regimes of fiscal inspections which discourages the tax evasion.

The analysis of the real information regarding the penalty rates and densities of fiscal audits corresponded to the sector where the evasions are efficient. Thus, for the density of audits created in 1997 amounting 8 per cent the penalty rate needed to be not 100 – 130 per cent, as it really was, but 1,150 per cent (!). And conversely, if the penalty varied in limits of 100-130%, then the density of fiscal controls had to be 43-50 per cent of all taxpayers. Besides, given the fact that collection of penalties is going very hard, it is necessary to make other measures to fight tax evasion.

First suggestion in this direction is the need to develop an ample study of the phenomenon. This study should include economic, sociological, juridical and psychological aspects. The problem is that the social - economic conditions created in the ex -socialist zone facilitate the avoiding of paying taxes. There exist economic models in the world practice which prove the fact that as long as the person realize that the tax evasion is widespread and he lives in an dishonest ambience, he concludes that his tax evasion will not change a lot the general situation, and essentially – his own benefits. As a result, he will decide to hide a part of his incomes.

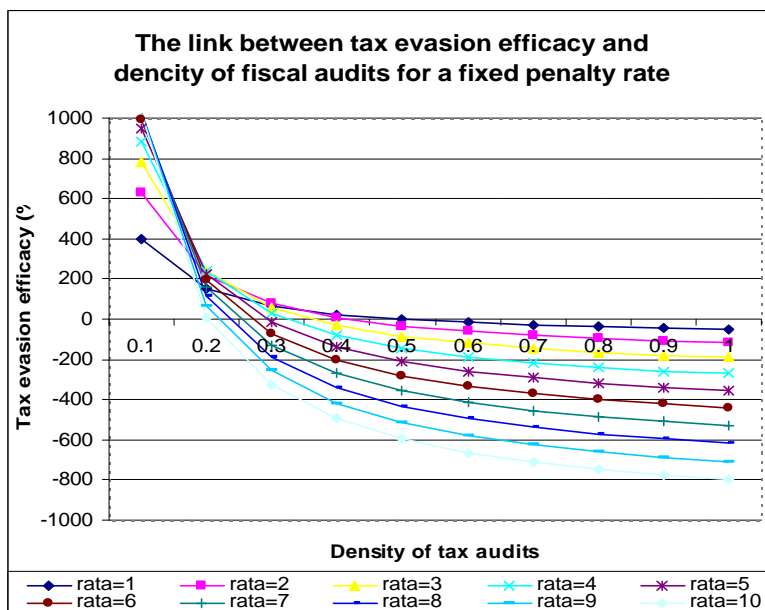
There are studies that prove the fact that the bigger is the income, the more he will be subject to tax evasion. The population having big incomes, who should, in principle, contribute the most of the budget revenue, will evade paying taxes in bigger proportions. In *countries with a dishonest ambience, the progressive tax system does not work efficiently. Formation of a state with a big share of medium size income population is the base of tax collection stability.*

Another aspect of tax evasion. *Studies of the psychological aspect of the tax evasion show* that independent of the real dimension of incomes, persons who complain about small incomes, about unfairness in evaluation of their work and aptitudes are more disposed to evade paying taxes, taking advantages from the state services to all population. That is why insufficient informing of the population regarding real incomes in society predispose to supplementary evasions. The information of the population regarding the buying capacity of the average wage, including various kinds of services and education in various countries could be beneficial.

As a solution for the creation of a more favorable ambience and amelioration of financial discipline, sociologists and psychologists propose the creation of various *educational programs of tax honesty*. According to the authors of these programs, education and moral appeal could have, probably, a better effect than high penalties.

Rise of the state authority in the public opinion can serve as a cheaper way of fighting tax evasion. Such educational programs could work more efficiently if being promoted by non Government organization, and financed by the state. They need to maximize the utilization of mass media and include the explanation of the following aspects:

- the tax system, in principle, is not bad and differs little from similar systems in the developed countries;
- the majority of taxpayers nevertheless pay their taxes;
- a convincing description of main directions of expenditures and explanation of their importance;



- description of possible consequences of tax evasion, including the personal risk and institutional consequences of an excessive punishment from the state;
- promoting a negative attitude to tax evasion, explanation of the fact that any tax evasion results simply in the tax burden's growth, and harms the rest of population.

Regretfully, especially in the countries having lower fiscal discipline, this educational work is not practiced at all.

Another aspect of tax evasion is that *the maturity of tax evasion reimbursement* is too long. Basically, the tax debts form a dead burden, which pushes more and more to the shadow economy not only the small businessmen, but also big enterprises, which resort to different manipulations with foreign accounts "run away" from this burden. Some studies of this phenomenon show that for easing this burden of taxes, which will never be paid anyway, a tax amnesty could be declared. *Negative and positive aspects of tax amnesty* could be distinguished.

The positive effects of the declaration of a tax amnesty include the following:

- *amnesty could offer a possibility to collect a part of tax debts, which in other case could not be collected;*
- the amnesty encourages honest declaration of incomes;
- amnesty makes the society more able to control its future, because the possibility of getting out from the shadow economy and entering the official one appears;
- amnesty makes possible to declare that a mistake was made, but now conditions for changing the behavior are created;
- amnesty can serve as transition to a new, softer tax regime, because when the Government fails systematically in promoting its tax policy, this could signify about a too heavy tax burden;

The negative effects are summarized in the fact that if this kind of amnesty is repeating, the population gets used to the fact that in any case they will be forgiven for breaking the law, this could undermine the authority of the Government and diminish the financial even more.

With regard to the Republic of Moldova, the utilization of different forms of tax amnesties becomes a too often used practice. In general, the population expects regular debt forgiveness, that is why it is necessary to examine carefully the possibility to continue this practice, or to declare clear that this amnesty is the last one and later the control work will be done with greater severity.

Fighting tax evasion needs to be done by all ways: economic, legal, administrative and educational.

The economic measures could include:

- increased fines and frequent inspections by fiscal institutions to such an extent that to make tax evasion unprofitable;
- wider and more active use of bankruptcy legislation;
- freezing enterprises' debts, deblocking of bank accounts and finding ways of cutting debts by taking into account the non-objective ways of their formation;
- diminishing the tax burden (the last one to be done only after accomplishing the others);

Legal measures would include:

- development of a legal system to promote economic measures;
- simplification of enterprise "shut-down" procedures for those that cannot prove their being in operation over an established period of time;
- implementation of the management law and means of its enforcing, providing management administrative and penal responsibility for not paying taxes and other payments due to the state;

Administrative measures would include:

- creation of a body endowed with functions and powers sufficient enough to fight tax evasion, including the right for investigation and application of administrative sanctions, to promote a single policy with regard to the investigation, discovering and penalizing people breaching the financial discipline;
- strict delimitation of functions of control institutions;
- building the prestige, quality and incentives of fiscal control institutions;
- ensuring transparency and free access of large parts of the population to the decisions made by state authorities, which might be an efficient measure of fighting corruption.

Educational measures:

- development of an awareness raising program explaining the implications of tax evasion on people's welfare, educating a negative attitude towards this phenomenon. This program is likely to be more efficient if conducted by non-governmental organizations and financed by the state;
- psychological education of economic agents with regard to the increase of severity on the part of fiscal control institutions via all available information channels (mass-media), explaining the positive effects of such measures, including eventual lightening of the tax burden.

Implementation of these measures could serve as first steps in fighting the parasitical phenomenon of tax evasion and could permit solving the problem of budget deficit, external debts, transition of the economy to a more civilized, stable, attractive for the international organizations and investors stage.

CHAPTER 4. SOCIAL DEVELOPMENT

Analysis of the current situation

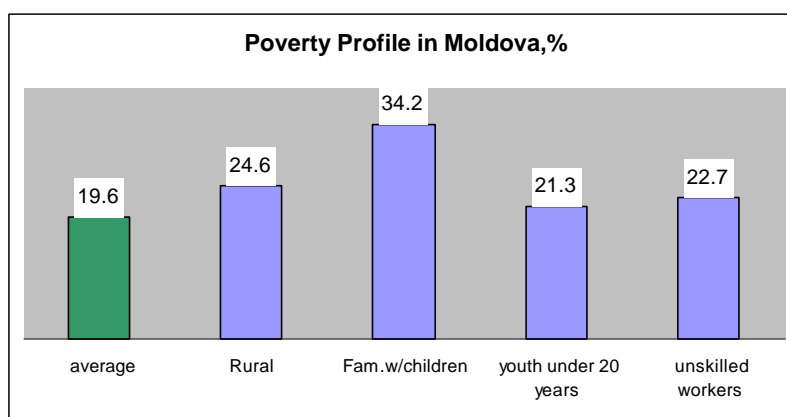
Recent evolution of the social sphere (in 1997 and the 1st quarter of 1998) confirm the trend of a dramatic worsening of this sector. Anti-crisis measures of the Government and the correction of 1998 budget (July 1998) will certainly have a dramatic impact on population's living standards. The galloping growth of pensions and salaries' arrears, accompanied by the erosion of real incomes of the population and enhancement of latent unemployment, amplifies the poverty and lack of people's confidence in the days to come, entailing a considerable increase of the social costs' burden. Although maintenance of macroeconomic stability (the major objective of the Government for the period under review) had a positive impact on the monetary policies, the precarious state of the public funds had a negative effect on the programs of the social protection of the population. Facing severe fiscal constraints, the Government did not succeed to provide for a proper financial coverage of the social costs. As a result, the discrepancy between the financial possibilities of the state and its social commitments has considerably broadened. By mid 1998 the social funds were in a sharp crisis, which endangers the fate of the social sphere in the future. Besides, the universal nature of the social protection schemes and wide spread of social benefits have considerably devalued their real value. Due to this, the social program efficiency is miserable, and the vulnerability risk extremely threatening.

Being treated as a secondary derivation of the economy, the reform of the social sector has been unwillingly delayed. The structure of social benefits and eligibility conditions, in most cases, remain to be those inherited from the old economic system. In addition to that, the legal framework is antiquated, frustrating the activity of the social employees. The performed modifications during the recent 7 years are perfunctory and often are at variance with the market

economy requirements. This is why, the social programs' solvency is low, badly impacting the public expenses. And that entails considerable worsening of principal social parameters, such as: living standards, health state, demographic composition and employment.

Life quality, as exponent of the social sphere performance, has considerably diminished during the period under review. The joint effects of the living standards decline are manifested in *extension of poverty*. In macroeconomic terms this is reflected in the small value of GDP per capita. According to an estimate of the World Bank, the average income of inhabitant of the Republic of Moldova amount to \$115 (adjusted to the Purchase Power Parity). This is one of smallest indicators registered in those 28 states in transition. Only Kirgizia ranks the last in the rating, by \$75 per capita. In microeconomic terms, the poverty is expressed through dramatic worsening of personal (family) budget's viability to cover the vital necessities. Although there is no formal quantification of the poverty line in the republic, nevertheless as preliminary scale, there may be the estimates attained from the household budget survey. According to that, almost 1/5 of the population has average monthly incomes below 64 lei, (which is regarded as poverty line). During 1997 the poverty line rose by about 13%, encompassing new social groups. From the viewpoint of the macroeconomic policies, these illustrate the need to budget means reallocate budget means to fighting poverty, which are estimated at about 7% of GDP.

Poverty profile has peculiarities specific to Moldova and derives from the insolvency of the public funds. The empiric evidences show that the individuals from the rural localities, families with many children, unqualified workers and



solitary elder are the groups mostly endangered by poverty. All these social groups outrun to a great extent the republican average of poverty (19.6%). Particularly, it has been proved that availability of children is mostly correlated with the probability to be affected by poverty. Thus, each 3rd family with children is in poverty, whereas the families without children have a poverty rate of 13.5%. The estimates show also, that the poverty is even deeper and more severe in rural localities, with unqualified workers and young under the age of 20. As a result we can conclude, that poverty will extend even more amongst vulnerable groups mentioned above, forming so called "poverty pockets". This trend will exercise severe impacts upon social assistance policies, requiring on behalf of the government urgent measures, with a view to localize and alleviate this phenomenon.

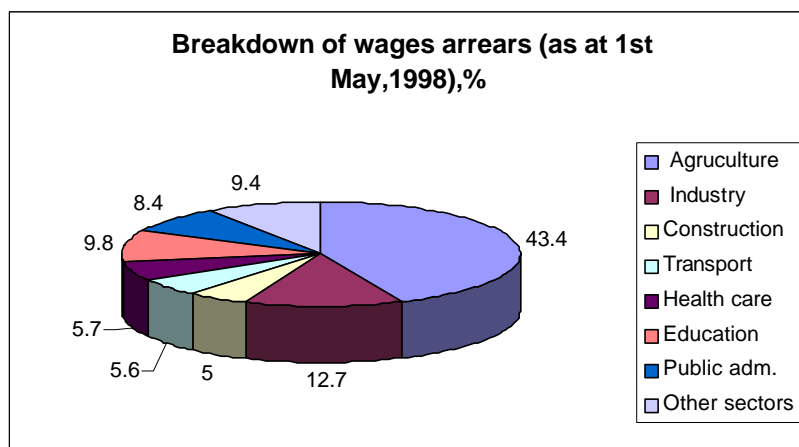
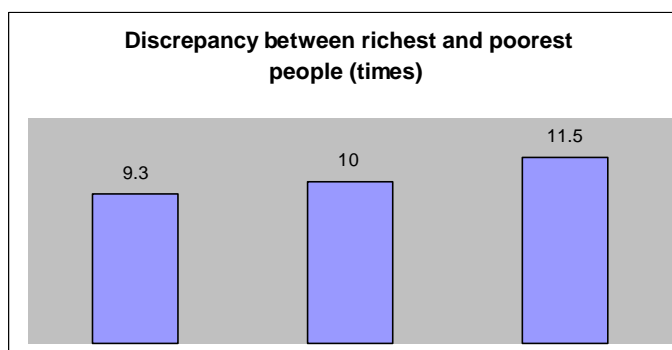
A derivation of the poverty is also the *discrimination of population in terms of incomes*. The *gini* coefficient, which estimates the degree of population income distribution, is 0.44. This index suggests that the incomes and expenditures of the population are distributed very uneven. The span of welfare differentiation is extremely large and constitutes 1 to 11.5. A mere extrapolation of the situation reveals the trend of concentration of wealth by a relatively small number of population. As confirmation there can be the results of the household budget survey, which demonstrates, that half of the overall income of the population is maintained by 1/5 of the population. Mostly poor stratum (20% of the population) gains only 4.3 of incomes. A thorough analysis of the social stratification shows, that the level of incomes varies pretty much, depending on the place of residence. By mid 1998 the discrepancy between the townspeople's incomes and those of villagers accounted for 62%, increasing almost twice in comparison with previous year. To mention is, that the gap between the

incomes is wider with the persons ranking in the lower part of the welfare rating, and is more uneven with the groups who have higher incomes.

Modification of incomes occurred under the influence of the consistent diminution of “cash” component and deepening the social stratification of the population. This fact reflects the crisis of public funds as a whole and of the remuneration system, in particular. Subsequently, the differentiation of labor remuneration deepened, in terms of branches and payments in kind. This is why the incomes of the population constitute at present only 60% of those registered at the moment of introduction of national currency – in 1993.

The composition of population incomes reveals the diminishing trend of salary share within the overall income of the population: from 74.5% on the moment of national currency introduction, in 1993, to 33.1% by the mid May 1998. These changes partially reflect the problem related to salary arrears and accuracy of provided data.

However it is true, that a good deal of salaries are paid in kind and typically are not recorded in books. Besides, the performed estimates cannot “catch” the structure of incomes gained in the informal sector and shadow economy. In this regard one can conclude, that the share of salary is somehow underestimated, yet, this does not change the picture of incomes as a whole. The configuration of incomes shows, that the private sources of income get a more importance in building up personal welfare. Thus, the incomes from real estate and financial transactions, including those in foreign exchange and intermediary activities, account for more than 1/3 of the gross income. This is a positive sign in the evolution of personal incomes; yet, at the same time it points the attention to the requirement of their formal bookkeeping. Although social transfers (indemnities, pensions and compensations) constitute an insignificant share in the families’ budget (14.8%), nevertheless, they are important



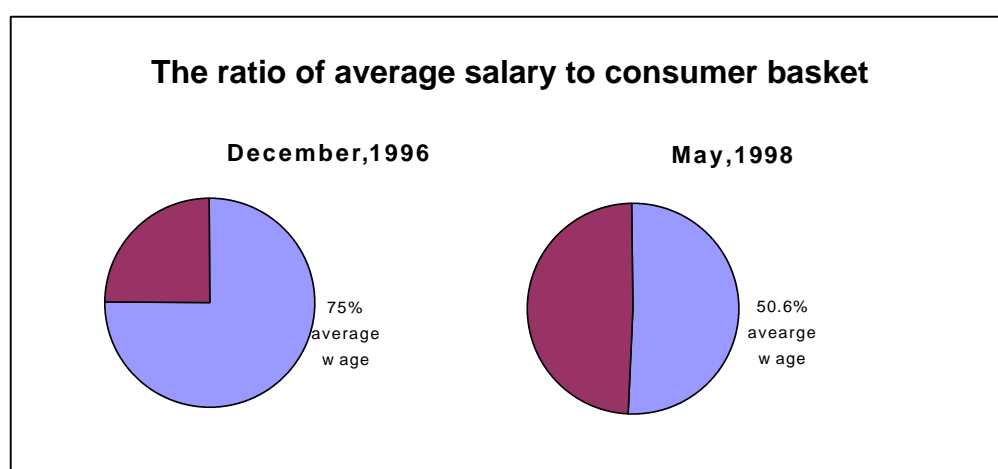
for the urban population. For this category of population, the benefits from social benefits rank 3rd in the overall structure of the personal welfare.

Relatively small are the incomes deriving from private and entrepreneurship activities, that account for only 5.5%. This fact proves the underestimation (hiding) of real incomes, as well as the existent barriers hindering this type of activity.

The disturbances taking place in the structure of personal incomes are conditioned basically by the incidence of the following two factors: non-payment of salaries in due course and big share of payments in kind. The problem of salary arrears reflects the overall financial instability in the economy and is directly correlated with the extremely poor solvency of the economic agents. Delayed salaries by 3-4 months and their partial payment created a difficult problem of “chronic” debts, which have poor chances to be settled in the near future. This is why, during 1997 and 1998 the salary arrears have considerably increased, exceeding the current payments. As of May 1st, 1998, the overall amount of arrears constituted 413.251 million lei. Only within one month (April '98) the salary arrears increased by 22 million. The critical situation in this regard, particularly

worsened in agriculture, industry, education and medicare, where the salaries were paid some 4-5 months ago. The perspective of paying-off salaries is ambiguous and depends in a great extent on the performance of the economic agents and financial management as a whole. Yet, this fact constitutes a guideline for a long run outlook. For short run there might be applied some untraditional measures. We mean first of all the possibility of the enterprises in collection of additional funds by privatizing, selling or leasing out some fixed assets. Besides, the state might issue 1-2 years treasury bonds in order to purchase the salary arrears to the employees of the budget sphere and public sector.

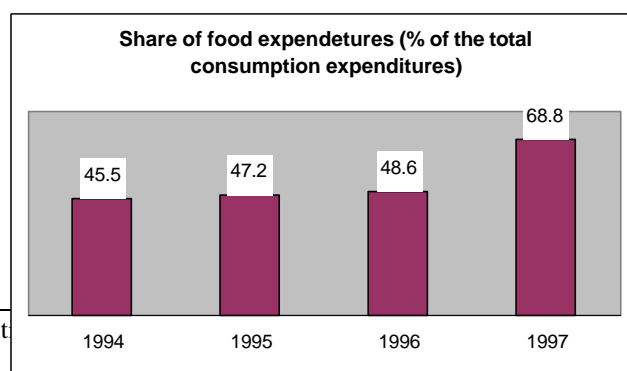
A derivation of big salary arrears - the share of *incomes in kind* - continues to grow. Thus the result of the household budget survey shows, that about 1/3 of the gross income is paid in kind. In rural localities this indicator accounts for 45.5%. The big share of incomes in kind is characterized to the states with low velocity of cash. Payment of a share of salaries, pensions and other transfers in kind can provoke severe distortions in cash circulation of a state and amplify tax evasion. This is why, urgent measures are required that would cease practicing payments in kind. For this purpose there might be used efficiently the fiscal leverage – lending for working capital.



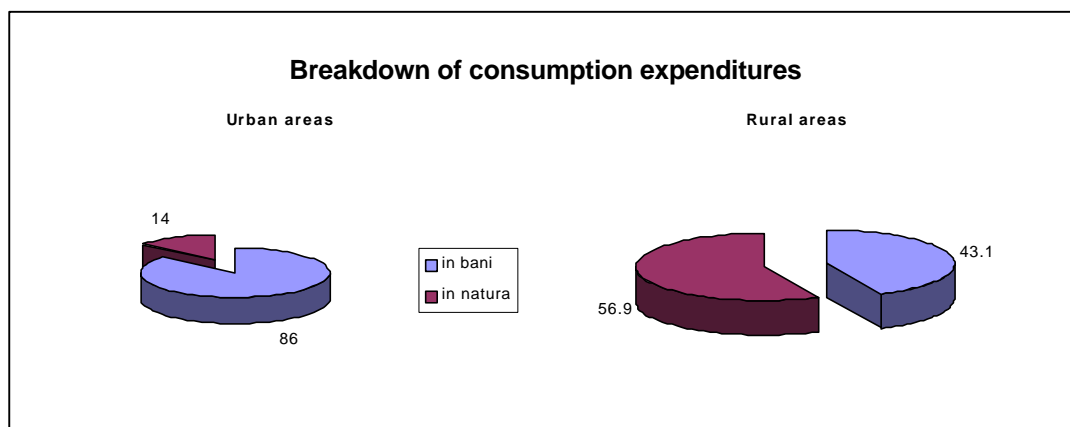
Another quite controversial aspect of the living quality is the parity of average salary within consumer price index. Although during the 1st quarter of 1998 there was noticed a slight increase of the average salary's share within the consumer price index, caused by the deflation (+3.4%), the discrepancy is still very large. In comparison with Dec. 1997, the *ratio of average salary to consumer price index* declined by 25%, currently constituting about 50%. Of course is disputable the validity of data and methodology of consumer price calculation, yet, even if these preliminary estimates denote the imperfections persisting in payment of labor. In this regard it is necessary to adjust the techniques and methodology aimed at real appreciation of those figures.

Practical implications of the ratio of the consumer price index to the average salary might be used in elaboration of social programs designed for poverty alleviation and granting social protection for vulnerable strata. Making this procedure operational requires the adoption of a respective legal framework, which would stipulate the minimal quantum of social benefits and their eligibility conditions.

The *consumption of the population* represents probably most painful point in the amelioration of the living standards of the population. The analysis of the statistical data and household budget survey discloses the poor content of consumption, characteristic to transition period. The big share of the food items in



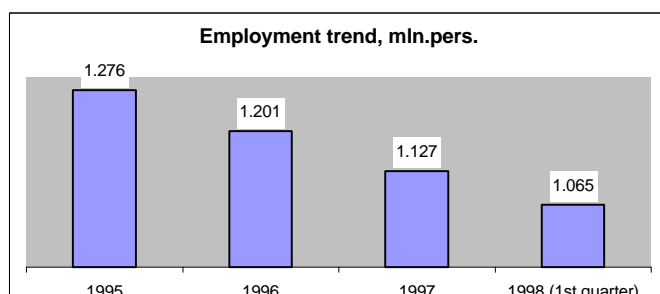
the overall consumption volume demonstrates the low level of population and high social costs that they incur. To mention is that recently there's been noticed a trend of exceeding growth of expenditures on foodstuffs. If in 1994 the population of the republic used to expend on average some 45.5% from the personal budget for purchasing food items, in 1997 this figure went up to 68.8%. The shares of food items vary considerably depending on the locality and material state of the person. Thus, the persons living in rural localities expend on foodstuffs 74% of their budgets, whereas those from urban localities – 63%. In addition to that, the expenditures for food grow exceptionally once with the rising of poverty level: the more material state is worse – the bigger are the food costs. For ex. the population of the first quintile (the poorest) pay 87.1% of the budget on foodstuffs, whereas the population of the 5th quintile (the richest) pay for that only 63.4% of the budget.



It is significant the breakdown of the food costs in terms of the form they are incurred. About 27% of them are expenses in kind that characterizes the deplorable situation of the labor payment; as well the pretty imposing role of the land plots in the overall consumption of the population. The share of expenses for food items made in kind is even more noticed in the rural localities. Only 20.4% are paid in cash, the other 79.7% representing expenses in kind.

Low incomes and delayed payment of salaries makes the population limit only to consumption of strictly necessary goods and services, such as communal services, public transport, heating, electric power. They rank 2nd in the structure of the consumption of the population and account for some 17%. The share of expenses for medicare, education and cultural activities has a constantly decreasing trend, which demonstrates the high price and difficult access of population to those services.

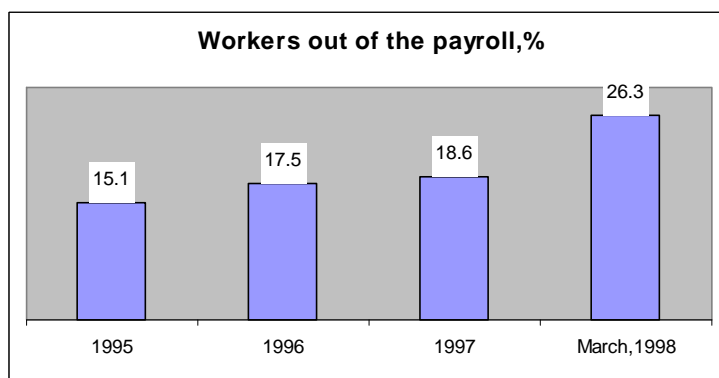
The *labor market* has a crucial impact on the living standards of the population. By offering varied possibilities of getting jobs and a high degree of job stability, this way the labor market constitutes to consolidation of population welfare. And conversely, the evolution of the recent situation demonstrates, that the labor market continues to face severe distortions, which destabilizes the reformatory processes as a whole. This fact is reflected first of all in the low capacity of the economy to absorb the available manpower. The investment activity of the economic units to create new jobs is still relatively poor. This is why we witness a considerable shrinkage of manpower demand. Only in the first quarter of 1998 the number of employees of the economic units decreased by 6%, constituting as of today 1.065 million individuals.



Staff was dismissed practically in all the spheres of the national economy. Dismissals occurred mostly in the agrarian and industrial sectors, registering an approximate fall of about 10%. In the

agrarian sector it occurred due to the problems regarding the brake up of large farms into smaller ones and a multitude of private undertakings that are not registered yet. In the industrial sector dismissal of man power occurred basically due to decline of industrial output and financial blockage of the industrial businesses and their restructuring, which obviously, require less man power. It is surprising, that the medicare, education and social assistance spheres registered a growth of manpower, although the salaries are mostly modest within the national economy, whereas capital investments have been for a long time in a profound decline. This unusual phenomenon, at first sight, may be explained by a relative stability of jobs in these branches, as compared with other sectors of the national economy (industry, transport, agriculture, etc.), as well as by the possibility to gain additionally from the individual (informal) activities.

The other aspect of manpower dismissal is *unemployment*. Although the officially reported employment rate continues to be extremely low – 2.3% (39.1 thousand individuals in the 1st quarter of 1998), in reality the situation is totally different. The data of the household budget survey denotes that only 41.5% of the questioned stated that are



officially registered as employees with any of enterprises. This is a very alarming signal, which can have hard consequences on the labor market. There is a growing trend of the unpaid leaves. The statistical data proves, that the share of people on such leaves accounts for only about 8% of the overall manpower. The shares of unpaid leaves vary from one sector to another. The largest share is in industry – 54%, and in agriculture – 13%. The medicare, education and social assistance suffered less of this problem – only 4% of employees have been forced on unpaid leaves. A more veritable picture on the labor market we get by making a comparable analysis of the employees, according to the staff and employees included in the pay-rolls. The difference between them shows us the really available manpower at the enterprises. Thus, the figures reveal, that the number of employees non-included in the lists (*i.e.*, who really do not work), but who are formally registered in the pay rolls of the enterprises, as of March 1998, account for about 26.3%. This figure is 1.5-fold more than in 1995 and has a constant growing trend. This phenomenon is more noticeable in agriculture and industry.

Being disappointed in finding a job within the national economy, more and more persons leave for work abroad. Thus, *labor migration* rises. To mention is that this phenomenon is semi-organized, often without assuring even the minimal social protection. From this point of view, the risk probability is very high. According to a study performed by the National Bank of Moldova it has been revealed, that the number of persons working temporarily abroad is about 20 thousand individuals. Most of them are worker professions, such as constructors, waiters and housekeepers. Higher education specialists are not desired abroad. The estimates of some independent experts report this figure amounts to 45-50 thousand individuals. We believe the second figure is closer to reality, because in both reports the average annual income attained by the migrants stands at 80 million lei. The geography of manpower migration comprises many states (Israel, Germany, Greece, and USA), yet; the bulk of the flow is oriented to Russia and other parts of the CIS (67%). Although labor migration offers additional opportunities to work and earn money, its adverse effects can have long run negative impact on the local labor market. Given that particularly the young (20-29 years), experience labor migration the losses (even temporary) of this segment can amplify the problems related to adjustment of qualified man power. Besides, the issue of undeclared (or under-estimated) incomes intensifies.

The cumulative effect of the social costs is reflected in the dramatic diminution of the *demographic parameters of the population*. Although recently a slight stabilization has been noticed in live expectancy, the demographic processes that occurred at the initial phase of transition, made the life expectancy in Moldova be one of the shortest in the CIS (70 years for women and 63 for men). The analysis of the demographic parameters show, that the trends that are manifested in this field impact negatively upon the composition of the population and structure of genetic fund in general. First of all the fall of the natural growth of the population (0.8 promiles in 1997), directly leads to absolute reduction of the population of the republic. During 1997 the intensification of this phenomenon accounted for 2%. This fall has been speeded up particularly under the impact of two factors: decline of birth rate and rise of mortality. In comparison with 1990 the birth rate fell by 1.5 times, whereas the overall mortality rate grew 1.2-fold. To mention is, that in 23 raions of the republic the mortality rate outpaces that of birth rate, and that is why the natural growth of the population is negative. Thus, the depopulation phenomenon extends, especially in rural localities. Simultaneously, there's observed an erosion of the family status. During 1997 the number of marriages diminished by 20%. The rate of infantile death keeps high (20 promiles), as well as that of the overall death rate. The latter increased during the last year by 12%, being mostly registered with the men of working age (18%), due to sicknesses of respiratory, digestive organs and cardiac-vascular system. Consequently the modifications that take place in the demographic composition of the population have an evident trend of aging. The decline of population segment under 15 and simultaneous growth of the one above 60 displays the aging trend of the population of the republic. Thus the rate of demographic dependence constitutes at present 61.4% in comparison with 51.2% in 1990. The modification that takes place in the demographic structure will impact negatively the social policies. In financial terms, this indicates a redistribution of the financial means within the social sphere in compliance with some priorities. In terms of social programs, this fact signals about the erosion of the public health and pressures, which will grow on behalf of the inactive population (elder, invalid, and numerous families). In this regard, implementation of sectoral social programs seems to be the opportune solution in the created situation.

Financial position of the social sphere

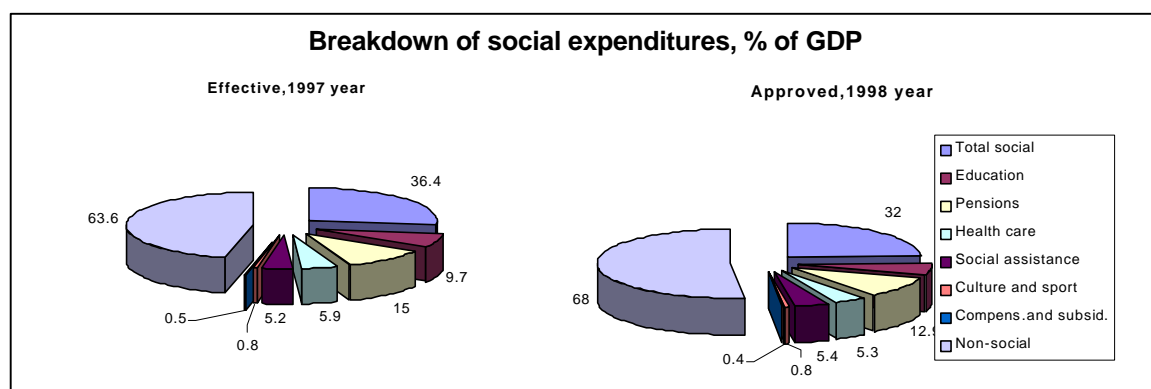
The evolution of recent events marks a considerable worsening of the social funds' trend. The flow of incomes does not comply with the effected expenses. The failures in collection of social payments and galloping growth of arrears amplify the public domestic debt. The discrepancy between the incomes and expenditures provoke hard distortions in the structure of the public expenses. Having no sufficient funds, a good deal of services transform simply in hardly realizable quasi-commitments. By mid 1998 the social liabilities' deficit (difference between the promises and current incomes) reached the figure of 43% of the GDP. Thus diminution of the social funds might seriously jeopardize the reforms progress.

Moreover, the universal nature of the social services and loose eligibility conditions impose the economic agents and budget to incur high financial costs. As attested by statistical data, the social expenses account for a considerable part of the GDP- circa 36%. In quantitative terms, this figure is comparable even with that of some western countries. However, in quantitative terms, their usage is net inferior even for transition countries. The efficiency of the public expenses is extremely low and contradicts the market economy requirements.

The structure of the social costs shows, that the biggest share account for pensions, (15%), then education (9.7%) and medicare (almost 6%). The other branches of the social sphere (culture, social assistance and sports) commonly account for slightly less than 6% of the GDP. The content of the social costs shows, that they are adjustable and are oriented mostly to *ad-hoc*

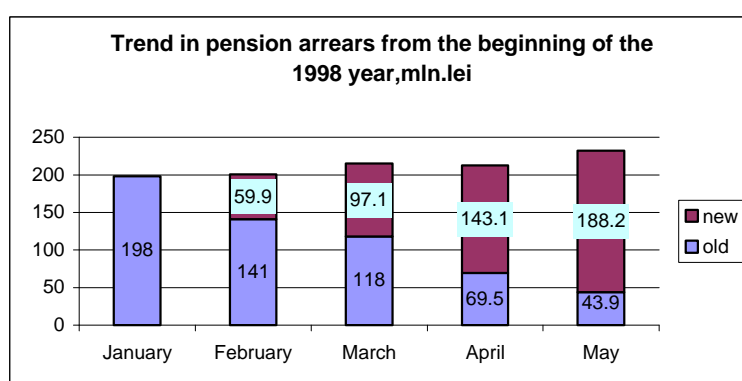
funding of social programs. The funds are typically allocated to those objects and programs that are in emergency state. Thus, there's an attempt to withhold further aggravation of the adverse phenomena and to localize them within that area. Yet, the effect of this model is for a short time and cannot resolve the problem essentially.

In line with the *ad-hoc* model, funding of the *current social expenses* is practiced, which in fact do not differ considerably. The explanation is, that in this case the cash is earmarked for funding the stringent current needs aimed at a superficial "repair" (improvement) of the situation. In both cases the volume of allocated funds is net inferior to the real needs. For ex. the education and medicare have been financed in volume of 45% of the required, education and science even less – only 1/3. Besides this functional structure of the social expenses shows, that at least 1/3 of them are expenses on the assets side (machinery, training stuff, professional training), the remainder being liabilities related expenses (salaries, taxes, capital repairs of buildings). Talking about the social expenses in macroeconomic terms, it should be mentioned that they are still public expenses (funded basically from the state budget and managed entirely by the state). The non-budget and non-state sources are still very insignificant. According to preliminary estimates, their share does not exceed 5% of the total volume of the social costs. Slightly more are the private resources aimed at funding the first medical aid and higher education. Of course, all these data are regarded partially as underestimates (given that many informal private activities in the social sphere are not book-kept), yet, in principle the situation is like this.



Maintaining the social funds only of public nature engenders serious discrepancies in the implementation of the social programs, essentially reducing their efficiency. This phenomenon's behavior can be easily illustrated by the example of the social fund. The monthly based data regarding the incomes and expenses show that the financial situation of the social fund is critical.

The poor solvency of the public pensioning system is significantly caused by the galloping growth of the pension arrears. Although during 1997 a reduction was reached of historical pension arrears by 90% (basically through payments in kind and netting), the problem continues to be a destabilizing factor of the public finance. The aggregate arrears



reached the figure of 232.1 million lei, considerably increasing during the 1st quarter of 1998. Braking down the structure of arrears shows, that the payment of the old arrears is made in small amounts. For example for May 1998 the old arrears were paid in amount of 25.6 million lei, whereas the new arrears grew by 40 million lei. This is why, the overall amount of the pension

debts grows considerably as a result of outpacing accrual of the new arrears as compared with the settlement of historical debts.

Insufficiency of cash imposed the social assistance bodies to practice the method of payment in kind. The span of this type of settlement varied from 49.5% (1st quarter of 1997) to 22.8% (4th quarter of 1997). In 1997, on average, each 3rd pension was paid in kind. Though in smaller size (22.8%), settlement of pensions in kind still continues. Partially this is linked to the considerable reduction of the volume of goods and products conveyed to the social fund by the economic agents as social contributions. Yet, the main reason consists in the refusal of the elder to accept the pension in kind (even partially) instead of that in cash. The prices of pension settlement in kind are too unfair.

The analysis of the funding sources of the social fund budget shows, that the perspective of the amelioration of the situation is very ambiguous. The statistical data confirm that the decline of social contributions' collection is deepening. If during 1997 the disbursements of the social contributions accounted for 51.8%, then in the 1st quarter of the current year their collection decreased to 35%. Non-payment in due course of the social contributions by the economic agents derives from the financial blockage they face. According to preliminary data, the accounts payable of the enterprises during the 1st quarter of 1998 grew by 43%. The fact is significant, that circa 2/3 of them constitute the debts to the social fund and labor remuneration. In these conditions it would be erroneous to believe, that the disbursements to social fund will be made entirely. As confirmation to those mentioned above, could be the statistical data, which prove, that only during June 1998 the debts of the economic agents to the social fund grew by about 65 million lei, amounting to an overall amount of 482.2 million lei.

The enormous discrepancy between the inflows (incomes) and outflows (expenses) confirm the assumption that the social sphere funds are on the edge of the crisis. The enormous fiscal burden borne by the economic agents and the antiquated manner of social disbursements can cause serious impediments to the financial system as a whole. Bearing in mind, that the critical situation of the budget system and the big commitments of the government to serve the public (and external) debt, we can conclude, that the amelioration of the social funds (at least during the recent 10 months) is mostly improbable. In this regard, the social fund budget for 1998 seems to be unreal. The reasons for a pessimistic scenario may be the aggravation of the decline of sources to compete the social fund and unjustified increase of various social privileges (facilities). The preliminary estimates show, that even if we keep the collection of contributions in cash equal to that the level of April 1998 (35 million lei – one of the highest indicators during the recent 2 years), the total amount of the disbursements for the remained period until the current year might hardly reach the figure of 400 million lei. At the same time, the payments to the social fund in kind decreased considerably: from 43% on average in 1997 to 18% in May 1998). From this viewpoint, we can forecast that incomes deriving from disbursements in kind will not exceed the amount of 80 million lei. Thus, the overall incomes into the social fund for 1998 will amount to only 500 million lei, which accounts for much less than the officially reported amount in the budget (1369.7 million lei). On the background of the small and pessimistic incomes, the expense part seems to be a banal joke. Forecasting a series of increases (of minimal pensions, special deserved pensions, for military, etc.), are just quasi-commitments without any financial background. Taking into account the enormous debts the government has to pensioners (232 million lei), we may conclude, that the burden of the social fund exceeds its real possibilities. All these together indicate that the social fund deficit can reach the amount of 630 million lei (7.8% of GDP).

Thus the estimates pointed above confirm the imminence of social funds adjustment to new realities. In this regard, urgent measures are required aimed at reforming both the inflows

(incomes) and outflows (expenses) of the social fund. It is particularly necessary, that the social fund budget reflects more realistically the collection of incomes and reduces unjustified expenses. Besides, the financial management of the social fund should be strengthened, by specifying clearly the distinction between the pensions and allowances. It is important to determine the functions and obligations of the state budget and of the social fund in covering the social costs. We consider, that the budget should limit only to granting benefits pertaining to social assistance (family allowances, for children, to the poor, etc.), whereas the social fund – to payment of pensions and unemployment programs.

Problems related to development of social sphere basic branches

Education occupies a specific place in human potential development. Providing various educational services and by developing the human intellectual faculties, educational institutions contribute this way to affirmation of civic positive position and formation of highly qualified manpower. From this viewpoint, the education is considered as precondition for deepening the economic reforms.

As many other branches of the social sphere, the education faces big difficulties that adversely effects the efficiency and quality of rendered services. These are financial, structural and managerial problems. For ex, although the GDP share earmarked for education exceeds 9% (indicator comparable with those of many western states), in reality expenses for education are extremely small. Calculations per pupil constitute only 684 lei, which is similar only to the developing countries. In 1997 from the state budget there were allocated 184 million lei, which constitutes less than half of the funds required by the training institutions. This is why, 10% of the total number of schools are in emergency state, and each 3rd – needs capital repair. A major problem continues to be the insufficiency of rooms for studies and the excessive number of pupils in a class. Thus, during the last year about 10% of the schoolchildren were going to school in the 2nd shift, in the urban localities this indicator is even higher – 17%. The normal capacity of classes is overburdened, often consisting of 35-40 children. In these conditions the quality of teaching is essentially suffering.

The private sector is still very timid and incoherent. Of those 3243 training institutions of the republic, only 25 are private. The share of students attending colleges and higher education institutions constitutes 15% of the overall. This figure is even smaller among the secondary general schools –only 0.26%. In these circumstances, obviously, the non-budget funds' contribution to financing the educational costs is symbolic – about 7% of the total amount necessary for this purpose.

In addition to the financial difficulties, the education has to overcome many problems related to the content and structure of education. They include the methods and antiquated techniques of teaching with most of the training institutions, curricula that do not fit to the actual requirements, incoherence in pupils' results assessment, insufficiency of manuals and modern teaching materials, poor motivation of teachers to perform efficient activities and others. As a result, so far no training institution of Moldova has been adjusted to the European standards. In addition to that, to mention is the situation of anarchy and lack of coordination that prevails in relation to entrance exams at the higher institutions. For ex. last year circa 40% of the school-leavers were registered at the economic specialties (banks, finance and bourses). This disproportion will create hard distortions on the market in the near future.

All together, the problems mentioned above can provoke serious disturbances in the activity of the educational system in Moldova. This is why, measures are required to avoid further diminution of the situation, that would facilitate the deepening of the reforms in this strategic

sector of the social sphere. In this context we consider opportune to focus the activities on the following two *priorities*: rationalization of budget expenditures and diversification of the non-state funding sources; adjustment of the programs and training techniques to the current requirement; consolidation of stimulants in teachers' activity. In operational aspect (in terms of programs) the realization of the above objectives can be reached in the following packets of *activities*:

- Revision of all curricula and their adjustment to date requirements;
- Priority funding and stimulation of commercial (private) activity of publishing manuals and training materials;
- Rationalization of budgeting and diversification of non-budget (non-state) sources of funding for public education;
- Acceleration of evaluation activity and accrediting of higher training institutions through European standards;
- Modification of current experience of teachers' remuneration and stimulation, making it flexible and in compliance to work performance;
- Elaboration of macro-national scenarios regarding the estimation of demand in preparing high quality specialists.

The precarious state of the *medical assistance* amplifies the negative demographic process and ruins the public health. The situation of the national medicare system is characterized by poor performance, insufficient funding and poor management. During 1997-1998 the dynamics of medicare indicators diminished considerably, dramatically nearing to a critical limit. The increase of infectious and socially contagious illnesses (tuberculosis, HIV, cancer, etc.) constitutes an alarming signal for the human genetic fund of the republic, which can affect seriously the demographic situation as a whole. The state of the adolescents' health state continues to worsen: circa 1/3 of recruited to the national army have severely affected health. At the same time the number increased of psychological deviations increased with the children, broadening the extent of the population invalidization. On the background of the general morbidity increases the pathology incidence of confined women and at delivery. Thus, as of the end of 1997 the maternal morbidity rate reached the figure of 48.3 promiles. Assessing the trend of the public health during the recent 2 years, to mention is that it was characterized to a large extent by the unstable sanitary-epidemiological situation and pathology chronicity.

Facing tough fiscal constraints, the Government is compelled to allocate less and less funds for health care. Thus, during 1997 the allocations from the overall budget shrunk by 3%, amounting to only 145 lei per capita. In macroeconomic terms, they constitute less than 45% of the required resources required in the field. At the same time, the structure of expenses remains to be irrational, which considerably reduces the efficiency of funds. Of the overall amount allocated to medicare, only 1/5 constitutes active expenses (procurement of medicines, medical equipment, personal training), the remainder (4/5) account for the communal services, labor payment and capital repairs of buildings. Distribution of funds between the two domains of medicare is inadequate too - only 18% are allocated for primary medical assistance (outpatient services and pre-illness diagnostics), whereas the funding of hospitals consumed 82% of the overall funds. Of course, this disproportion in distribution of financial resources is far from contributing in making the active-preventive measures more efficient.

Is pretty low the development of private sector in the field of medicare. The statistical data shows that the paid medical services rendered to the population in 1997 made up only 1/10 of the overall expense. Per capita they make up only 3.18 lei, which is slightly more in the urban localities (Chişinău – 5.65 lei and Bălţi – 6.85 lei). Obviously, in these conditions the budget cannot support entirely the medical assistance, which becomes more and more costly. It is

necessary to both rationalize the public funds earmarked for medicare, as well as the branch as a whole.

Taking into account, that the macroeconomic environment in which the medicare performs its activity in Moldova, as well as the trends manifested recently in this domain, we can conclude, that the perspective of the amelioration of the situation, based entirely on the support of the state, is pretty ambiguous. The viability of the branch depends to a great extent on the pace and degree of reforms. From this point of view, we consider opportune to speed up the reforming actions, focusing on the following priorities:

- Modification of public costs' structure, by increasing the share of allocations for primary health care (preventive diagnosis, prophylactics and out-patient services);
- Enforcement of law regarding the obligatory medical assistance of citizens;
- Development of a minimal packet of medical services guaranteed by the state and funded from public budget;
- Stimulation (encouragement) of private sector development and competitive behavior in rendering medical-curative services;
- Decentralization of medicare net, by granting real autonomy to medical units;
- Elaboration of national sectoral programs aimed at fighting the socially contagious sicknesses (cancer, HIV, diabetes, environment hygiene, etc.).

Social protection of the population besides the macroeconomic difficulties, faced by the whole economy, has to overcome atavisms inherited from the old system of the social benefits. Preserving the public nature of the social funds means to expose the social sphere to certain hazardous, long run disturbances. This is why, the structure of social costs needs to be rationalized and eligibility criteria revised. The social protection needs to gradually shift from the principle of universal distribution of benefits to that of individual accumulation. It is important, that the burden of social expenses be evenly borne by all individuals, economic units and state. In this regard, a closer correlation will be provided between the beneficiaries and taxpayers.

Social protection reform will run in conditions of tight *fiscal and political constraints*. They will be noticed pretty much in the immediately forthcoming period (1998-1999), as a result of the external debt of the republic and amplification of budget deficit. The vulnerable point in the activity of the social protection system constitutes its financial viability, which is almost collapsed. The designed transformations need to be implemented in line with the measures aimed at improving the consolidated state budget. The immediate aim is to offset the incomes with expenses, based on the enhancement of budget accumulations and reduction of unjustified financing. For this purpose it is important to provide for financing of current social payments for pensions and salaries, by suspending the plans (intentions) to rise wages or other indemnities.

Although the strategic objective in the pensioning filed envisages a gradual shift from the current universal system to three-dimensional one, *priority* should have measures of rationalization of current pensioning fund budgeting. In terms of *urgent policies*, the actions should be channeled to the following directions:

- Freezing up any increase of pensions until the pension arrears are not entirely paid off;
- Ceasing for a longer term the payment of particular-deserve-pensions and those granted in privileged conditions;
- Reduction of pensions and compensations to working pensioners;
- Elimination of compensations for gas and electric power, by shifting the social assistance to vulnerable social groups;

- Banning netting with the social fund;
- Ceasing the experience of paying the pensions in kind;
- Restructuring the debts of the social fund to pensions and indemnities;
- Strengthening the financial management regarding the accumulation and distribution of social contributions.

In order to make the targeted measures operational, it is necessary to establish an adequate legal framework. It is necessary to update certain legal acts and develop some new, such as the laws: regarding state pensions, operationalization of private pension funds, social fund, state social insurance, private social insurance, etc.

As regards *social assistance*, it will play an important role in amortizing the social costs. Proceeding from the budgetary constraints that the social fund is going to face during the forthcoming months, it is necessary, that the funds be channeled mostly to *protection of most needy strata* and those easily vulnerable to risks. For this purpose, the results of the household budget survey may be used, for identifying the vulnerable groups and determining the social assistance quantum. As proved by the poverty profile in Moldova, mostly affected category comprises families with children (76% of the total number of poor account for the families who have at least a child under 15). This is why, the children should be placed in the focus of the social assistance efforts. We consider opportune to substitute the multitude of family allocations (for children) with one single – poverty allowance. This will exclude incoherence and will be more explicit for beneficiaries. It will be granted only to vulnerable individuals, based on the means testing.

Given that the social funds will be extremely limited in continuation, the social transfers need to be distributed to a high extent in terms of concrete addresses. For this purpose it is necessary to make tougher the current eligibility conditions, by reducing essentially the list of recipients. The size of indemnities (social allowances) should be as flexible as possible and vary depending on the category of beneficiaries and degree of their need. At the same time, the social costs should be maintained at a prudence level, in order to avoid a potential deepening of budget deficit.

Assessment of current situation and development of eventual scenarios shows, that besides the measures aimed at speeding up the social reforms, urgent actions are needed to recover the social finances. Social budget's adjustment to reality might make public expenses more efficient and facilitate promotion of their reform as a whole.

CHAPTER 5. REGIONAL DEVELOPMENT: A CASE OF TRANSNISTRIA

The Program of Activity of the new Moldova's Government, approved by the Parliament in May 1998, among priorities includes "*restoration of the territorial integrity, formation of a sole viable economic complex, in conditions of market economy*". Following after well-known events of 1992, the economy of Transnistria has been developing in its particular conditions, differing from those of other regions of the country, a fact which should be taken into consideration both while running the territorial-administrative reform in Moldova, and while implementing the European

norms of local self-administration in compliance with the *European Charter of Local Self-Government*, ratified by the Parliament of Moldova in July 1997.

One of the tasks of the new Parliament is to generate a national legislation in line with the Charter, including the laws “On Territorial-Administrative Organization”, “On Local Self-Government” and “On Elections of Local Administration Offices”, the drafts of the above having been submitted to the commissions of the Parliament for almost an year.

Europe operates today in the context of a new juridical, political and social-economic reality: *regionalism* is manifesting itself in increasing the rights and responsibilities of regions in some countries (Germany, Spain, Austria, etc.), and developing cooperation among regions, across national borders.

In the case of Transnistria, as for regions in other countries, the key problems are: (i) *how to distribute responsibilities between the central and regional governments in the best possible way for the country and the region; and (ii) how to ensure that the process of decentralization does not undermine the national state.*

Solution of the problem related to Transnistria will not be easy, ways continue to be sought, including through providing with analysis and information. Below, there is a digest of the Report “Republic of Moldova: Economic Review of the Transnistrian Region” (World Bank, Chi” in”u, June 1998).

* * *

Since 1992, the Transnistria region, an economically important part of the Republic of Moldova located on the east bank of the Nistru river, has suffered self-imposed isolation from the rest of the country and, for the most part, from the world at large. This isolation arose as a consequence of unsettled conflict in which ethnic and language factors exacerbated the marked differences in approach to economic reform.

In Soviet times, Transnistria was considered the most economically developed region of the Moldovan Soviet Republic. According to rough calculations, it accounted for more than a quarter of the republic's gross domestic product (GDP). It produced more than a third of total industrial output, including about 90 percent of electricity, all steel and rolled metal, and most heavy industrial equipment, construction materials, and light industrial products. Transnistria's contribution to agricultural output was less important (about 10-15 percent), but agriculture was more productive compared with that of the rest of the republic. Due to its geographic location, the region has always been a natural hub for Moldova's trade with the east in respect to both land transportation and energy pipeline connections.

The Transnistrian conflict has considerably complicated Moldova's transition to a market economy. Disintegration of the internal market has weakened the economic potential of the country. Already extremely high dependence on energy imports has deepened. Competitiveness of exports has suffered as use of the most convenient transport routes to major export markets has been blocked for the majority of economic agents. De facto separation and lack of structural reforms in the Transnistria region have provided a large window for opportunity for various forms of shadow economic activities. Moldovan authorities have repeatedly expressed concern about governance problems arising from the Transnistria situation, including numerous cases of unrecorded foreign trade, tax evasion, and smuggling resulting from the lack of effective control over the eastern border with Ukraine. Compounding the tangible economic damage has been the negative effect of the conflict on the image of Moldova in the eyes of the international community; this has hurt its chances of competing for new markets, making new trading partners, and attracting foreign investors.

Transnistria's move towards isolation was manifested in a number of radical steps taken in 1992-93 to establish separate economic institutions. The Transnistrian Republican Bank (or the Transnistrian central bank, TRB) issued a separate currency that is not recognized outside the region. Fiscal policy is also managed independently from the rest of the country. The region has established its own customs service and maintains a distinct trade regime. Trade with the west bank territory of Moldova is treated as foreign trade. Although division of the energy sector, which is crucial for the whole country due to its dependence on imported energy resources proved to be impossible, coordination between the two parts of the country is limited. The fundamental legal framework for market economy adopted by Moldova in recent years has not been accepted by the Transnistrian authorities and does not function in the region. No statistical data have been provided officially from the Transnistria region to Moldovan authorities since 1992.

It would be wrong to say that the central planning system has remained unmodified in the Transnistria region. Although no official program of market reforms has been implemented in Transnistria, the regional authorities did not cancel liberalization measures already undertaken in Moldova before separation. Furthermore, they have attempted to introduce some new, select elements of a market economy while maintaining many aspects of the old Soviet style economic system. In addition, in several areas de facto liberalization took place during the initial period of economic chaos and lack of supervision by regional authorities. The majority of prices are now free of controls and the foreign exchange market is developing. Commercial banks operate actively and new private firms have begun to emerge. The actual trade regime is much more liberal than the one proclaimed officially as a consequence of weak customs controls and the unsolved problem of regulating trade relations between the east and west bank territories.

Selective liberalization measures were not supported by macroeconomic stabilization and structural reform, which resulted in a severe economic crisis. For several years, monetary policy in the Transnistria region was characterized by chaotic developments and the absence of any real control mechanisms. Budgetary and credit policy remained largely a tool of politicians, who used it without regard to economic consequences. Few, if any, structural reforms have been implemented in Transnistria. Executive and legislative authorities have failed to achieve consensus on the main principles of reform, including the role of private property and the functions of the state in the economy. As a result, the public sector dominates production and distribution, and the private sector is relegated to a minor role. This stands in sharp contrast with the rest of Moldova.

Starting in late 1995, the Transnistrian authorities appeared to make more concerted efforts to respond to the deteriorating economic situation. Measures were taken to keep the monetary and financial crisis from deepening further. The role of the TRB was strengthened, and a concerted effort was made to establish its control over the monetary and credit situation in the region. A tougher stance was taken in issuing new currency. The TRB refinance rate began to be adjusted to inflation and it replaced the symbolic interest rates fixed by the Transnistrian Supreme Soviet (or regional Parliament, TSS). The TRB began to intervene more actively in the foreign exchange market. Parallel measures were undertaken to reduce the fiscal deficit and to find nonmonetary sources for its financing. However, budgetary policies remained contradictory, as soft budget constraints persisted and the Soviet-type pattern of public expenditures essentially remained the same. Supervision over commercial banks was strengthened through the introduction of prudential standards and the gradual increase in required minimum statutory capital. Some steps were taken to reanimate the process of privatization. The basic legal framework for expansion of nonstate

forms of ownership in the region was approved by the TSS. However, the legislators' inability to reach consensus on the implementation mechanisms resulted in the failure of most of the laws to work in practice. The authorities made visible efforts to attract foreign investors to the region. Various forms of cooperation between the Transnistrian enterprises and foreign partners were encouraged, with some modest results.

Internal measures aimed at redressing the crisis were accompanied by a number of partial steps in the direction of economic reintegration with the rest of Moldova. In 1995-97, several important economic agreements were signed between the Government of Moldova and the Transnistrian authorities, which were aimed at eliminating some of the most distortionary inconsistencies in economic regulation between the two territories. These agreements, which include, inter-alia, measures to simplify foreign exchange and trade relations, could form a substantial basis for future economic reintegration in case of their full implementation. An agreement on the relations between the monetary and credit systems was signed in mid-1995. In particular it envisaged official introduction of the parallel circulation of the Moldovan leu as legal tender for noncash transactions in the territory of Transnistria. The National Bank of Moldova subsequently opened a branch office in Tiraspol, which functions as a settlement center for transactions between the commercial banks of the two territories. However, Transnistrian commercial banks prefer to maintain direct correspondent relations with the banks in Chiºinu, and the level of transactions channeled through the settlement center remains insignificant. A customs agreement was signed at the beginning of 1996, which envisaged the Transnistrian authorities taking some important measures to adapt their foreign trade regime and eliminate most differences with the national trade regime. Although import tariff rates for nonfood products, tobacco, and beverages have been increased to the national levels, the greatest part of the customs agreement remains to be implemented. These agreements were followed by the signing in May 1997 of a memorandum on the principles for settlement of the conflict. The memorandum envisages a final status that would accord Transnistria a substantial amount of economic autonomy within a unified national framework. However, the timetable for reaching a final settlement remains uncertain.

Although the recent efforts of the Transnistrian authorities to stop the deepening of the crisis and to upgrade economic ties with the west bank have brought partial results, the measures undertaken have not been sufficient to stabilize the economy. The deliberate policy of isolation, combined with the lack of comprehensive macroeconomic stabilization efforts and a reluctance to carry out structural reform, has resulted in major economic difficulties in the Transnistria region. Measured by most comparators, these difficulties are considerably greater than those faced by the rest of the country. After a period of accelerated deterioration in economic conditions, which reached a peak in 1995, some relative improvement occurred in 1996-97. Nevertheless, the region's economy is mired in a deep recession, and living standards have dropped sharply.

The monetary and financial situation remains very unstable. The region continues to suffer from high inflation, although price growth significantly decelerated in 1997. The average monthly inflation rate was below four percent in 1997, compared to more than 50 percent in 1995. In step with the inflation rate, depreciation of the Transnistrian ruble (TR) slowed down, but has not yet stopped, even with active TRB interventions. Indeed, the local ruble fell sharply in March 1998. Local economic agents generally substitute foreign currencies for the local currency. After a near collapse of the regional budget in 1995, some rehabilitation of the budgetary system has taken place, but the overall financial situation remains extremely fragile. Payment arrears have become

chronic. The largest and most acute financial problem is the huge amount of accumulated external arrears to Russia for energy resources, which makes up about half the energy debt of the whole country. These arrears have become, in fact, a massive subsidy to the economy of the region and a major liability for the future.

Both industrial and agricultural outputs continue to decline. In 1997, industrial output was about 70 percent below the 1990 level. According to rough estimates, the relative share of the region in the Moldova's total industrial output has fallen by about 7 percentage points due to higher rates of decline compared to the west bank territory. However, at the micro level, the situation is differentiated. Amid the continuing decline in physical output of most industrial products, there are some exceptions. More favorable trends in the production of a number of products (e.g., steel, rolled metal, slate, cement) are associated with more effective management policies at a few leading enterprises. In general, these firms had better starting conditions in terms of internal organization, management and labor skills, and competitiveness. They managed to adjust more quickly when the command economy was dismantled *de facto*. Agricultural output has also been declining at a faster pace than in the rest of the country. The fall in agricultural output has been accompanied by a decline in yields relative to the rest of Moldova. This has resulted in a loss of a comparative advantage for many important agricultural products (cereals, sunflower, vegetables) which Transnistria used to enjoy in the Soviet times.

Recession in the main productive sectors has generated high levels of hidden unemployment in the form of forced underemployment in the public sector. Even though a large part of those underemployed succeed in finding alternative jobs, the underlying unemployment rate is estimated to be at least 7 percent of the labor force.

Poor economic policies followed by a long-lasting economic crisis in the region has led to a sharp fall in living standards. In 1995-96, average wages were about 20 percent below the average for the rest of the country. In comparison, at the time of the breakup of the Soviet Union, Transnistria had better starting conditions in terms of wage levels than the west bank territory. In 1997, however, the difference in wage level practically disappeared. This is probably a temporary phenomenon, since it is primarily a consequence of administrative increases in wages decreed by the regional authorities. Indeed, the Transnistrian ruble depreciated sharply in mid-March 1998, from TR 650,000 to TR 1,200,000 per US dollar, implying a potentially important erosion in real wages. Total household revenues on average do not exceed US\$35 per capita. The urban majority of the Transnistrian population appears to be significantly poorer than the rural minority and the urban population of the west bank territory. The two major factors that probably prevented household revenues from an even deeper fall are (a) populist social policies of the Transnistrian authorities conducted at the expense of financing the economy through the accumulation of external arrears, and (b) the availability of alternative revenue sources, including a large share of revenue earned from household agricultural production.

It is clear that the policies followed by the Transnistrian authorities of isolation and piecemeal reforms combined with heavy reliance on external subsidies are associated with high risks and are inadequate to create internal conditions for stabilization and economic growth in the region. It is true that, despite all the difficulties, the region's economy has avoided collapse so far. The following three factors are probably the major determinants behind this phenomenon: (a) *de facto* liberalization in a number of areas, which in many cases took place spontaneously; (b) massive external subsidy to the whole economy; and (c) partial reforms undertaken by the authorities under the danger of full economic collapse. The first two of these factors are not under

the control of the regional authorities and could exert destabilizing influences in the future. Only the last factor can really contribute to the conditions for stabilization and growth in the longer term. Partial efforts to reform some elements of the economic system should be developed into a comprehensive market reform program. To achieve this, much greater effort is needed on the part of the Transnistrian authorities, particularly in the areas of macroeconomic stabilization, privatization, external trade liberalization, and general reform of the legal framework, in order to create conditions for stability, growth, and economic reintegration. Most elements of this reform program exist within the national framework already adopted by the west bank of Moldova. In practice, this framework could be readily expanded to include Transnistria while making the adjustments required to take into account the specific characteristics of the region.

Economic benefits of reintegration for both parts of the country are clear. Only through economic reintegration can Moldova realize its full internal economic potential and maximize external competitiveness. For the Transnistria region, reintegration would precipitate accelerated economic reform and provide stable economic linkages with the rest of the country and the outside world, without which its tiny economy would be unlikely to survive and prosper in the long term. However, economic reintegration cannot be expected to happen by itself. The prospects depend on achieving a final political settlement of the conflict which is a great challenge facing the Moldovan Government and Transnistrian authorities. There are obviously many social, ethnic and linguistic factors to be taken into account. A strong will, as well as great effort are needed from both sides to reverse the process of separation which has developed over the last five years.

CHAPTER 6. ANNEXES

6.1 Selective indicators of countries in transition

For the Republic of Moldova the experience of other countries in transition is quite important. The following comparative analysis provide a picture of Moldova within other countries in transition from Central and Eastern Europe. Table 6.1.3 ranks these countries according to a selection of indicators for reform, while Table 6.1.1 and 6.1.2 give a more specific picture of the GDP growth performance and inflation over the recent years.

Table 6.1.1 Selected group of Countries in Transition: Real growth of GDP: 1990-97

	1990	1991	1992	1993	1994	1995	1996	1997
	percentage change							
Albania	-10.0	-27.7	-7.2	9.6	9.4	8.9	9.1	-7.0
Bulgaria	-9.1	-11.7	-7.3	-2.4	1.8	2.1	-10.9	-7.4
Croatia	-6.9	-19.8	-11.1	-0.9	0.6	1.7	4.3	6.3
Czech Republi	-1.2	-11.5	-3.3	0.6	2.7	5.9	4.1	1.2
Hungary	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.0
Moldova	-	-	-	-1.2	-30.9	-1.9	-8.0	1.3
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9
Romania	-5.6	-12.9	-8.7	1.5	3.9	7.1	3.9	-6.6
Slovak Republ	-2.5	-14.6	-6.5	-3.7	4.9	6.8	7.0	5.7
Slovenia	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.1	3.7
Ukraine	-4.0	-8.7	-9.9	-14.2	-22.9	-12.2	-10.0	-3.2

Source: *International Financial Statistics*, IMF and *Transition report*, EBRD

Table 6.1.2 Inflation in Eastern Europe

	1991	1992	1993	1994	1995	1996	1997
	(change in the year-end retail/consumer price level, in per cent)						
Albania	104	237	31	16	6	12.7	32.1
Bulgaria	339	79	64	122	33	123	1,089
Croatia	250	938	1,149	-3	4	3.5	3.6
Czech Republi	52	13	18	10	8	8.8	8.4
Hungary	32	22	21	21	28	23.5	18.3
Moldova	-	424.3	393.6	76.1	21.7	15.1	11.2
Poland	60	44	38	29	22	19.9	15
Romania	223	199	296	62	28	38.8	154.8
Slovak Republ	58	9	25	12	7	5.8	6.2
Slovenia	247	93	23	18	9	9.7	9.1
Ukraine	161	2,730	10,155	401	182	80.2	15.9

Source: Based on EBRD, *Transition report 1997*

Table 6.1.3 Progress in transition by countries

Countries	Population (millions, mid-1995)	Private sector share of GDP in %, mid-1997 (rough EBRD estimate)	Enterprises			Markets and trade			Financial institutions	
			Large-scale privatisation	Small-scale privatisation	Governance & restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions
Albania	3.2	75	2	4	2	3	4	2	2	2-
Bulgaria	8.4	50	3	3	2+	3	4	2	3-	2
Croatia	4.8	55	3	4+	3-	3	4	2	3-	2+
Czech Republic	10.3	75	4	4+	3	3	4+	3	3	3
Hungary	10.3	75	4	4+	3	3+	4+	3	4	3+
Moldova	4.4	45	3	3	2	3	4	2	2	2
Poland	38.5	65	3+	4+	3	3	4+	3	3	3+
Romania	22.7	60	3-	3	2	3	4	2	3-	2
Slovenia	2	50	3+	4+	3-	3	4+	2	3	3
Ukraine	51.9	50	3-	3+	2	3	3	2	2	2

Source: Based on EBRD, *Transition report 1997*

The classification system for transition indicators has the 1-4 scale indicating the scale from the worst category 1 (little progress) to the standards and performance of advanced industrial economies (4).

The “private sector” of GDP represents rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available. Here the term “private companies” refers to all enterprises in which a majority of the shares are owned by private individuals or entities. The roughness of the EBRD estimates reflects data limitations, particularly with respect to the scale of informal activity. The EBRD estimates may in some cases differ markedly from available data from official sources on the contribution to GDP made by the “private sector” or by the “non-state sector”. This is in most cases because the definition of the EBRD concept differs from that of the official estimates. Specifically for the CIS countries, official data in most cases refer to value added in the “non-state sector” – broad concept, which incorporates collective farms as well as companies in which only a minority stake has been privatized.

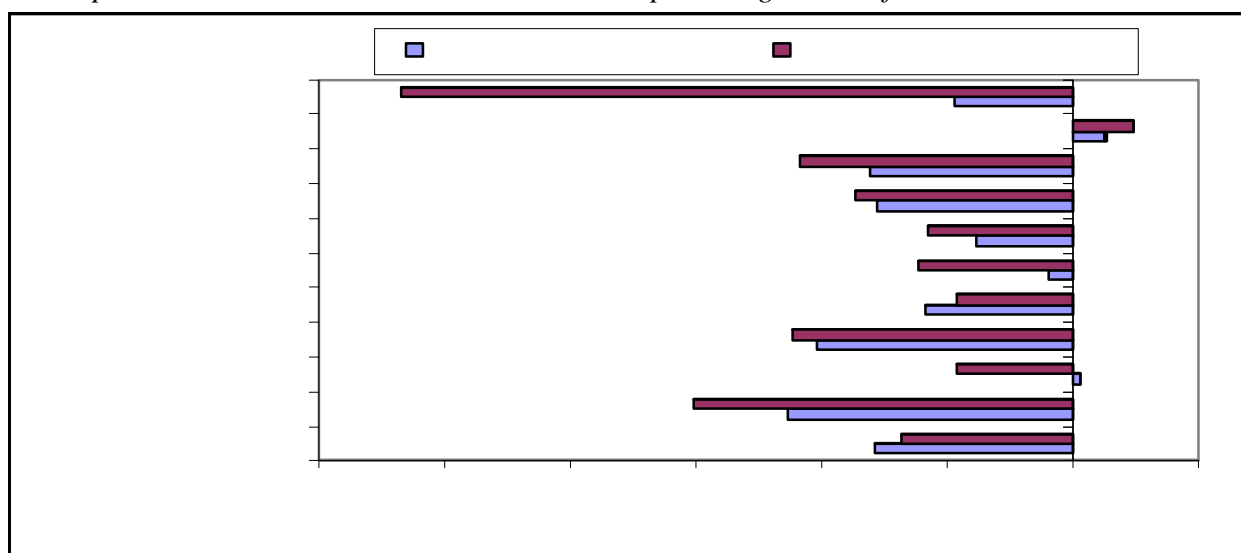
In recent years, most of the East European countries have registered a growing trade deficit and a continued deterioration of their current accounts.

Table 6.1.4 Current account and trade balances in Eastern Europe

	Current account balance 1996	Merchandise trade balance 1996	Current account balance 1996	Merchandise trade balance 1996	Change in current account balance 1995-96	Change in merchandise trade 1995-96
	(in million US dollars)		(in per cent of GDP)		(Change in GDP share 1995-96)	(in per cent)
Albania	-123	-692	-4.7	-26.7	2.7	-7.1
Bulgaria	117	209	1.3	2.4	1.8	1.5
Czech Republic	-4,476	-5,972	-8.1	-10.9	-5.3	-3.4
Macedonia	-288	-317	-7.8	-8.6	-1.7	-2.4
Hungary	-1,700	-2,600	-3.8	-5.8	1.9	-0.4
Moldova*	-188 (-295)	-252 (-344)	-11.3 (-15.8)	-15.1 (-18.4)	-2.8 (-4.5)	-11.9 (-3.3)
Poland	-1,352	-8,154	-1.0	-6.1	-5.7	-4.6
Romania	-2,336	-2,130	-5.9	-4.6	-1.0	-0.1
Slovak Republic	-1,941	-2,106	-10.2	-11.1	-8.0	-9.8
Slovenia	47	-853	0.3	-4.6	-1.7	-3.1
Ukraine	-1,184	-4,296	-7.9	-6.8	1.5	-3.5

Source: Based on EBRD, *Transition report 1997*

* Data for 1996 are revised by MET. Data in brackets are for 1997.

Graph 6.1.1 Current account and trade balance, percentage share of GDP; 1996Source: Based on EBRD, *Transition report 1997*

In general, foreign direct investment has continued to flow into the region at a rapid pace. It has to be mentioned that several large infrastructure privatization's in Hungary (power sector) and the Czech Republic (telecom) taking place in December 1995 distort the annual comparison. In 1996 Poland replaced Hungary as the leader recipient of FDI. Concerning Moldova, the flow of FDI are registering one of the lowest value in CIS countries and Eastern Europe.

Table 6.1.5 Foreign direct investment for selected countries; 1994-96

Countries	1994	1995	1996	FDI inflow per capita 1996	FDI inflows as % share of GDP 1996
	(in million of US dollars)			(US dollars)	
Albania	53	70	90	28	3
Bulgaria	105	82	100	12	1
Croatia	98	81	349	73	2
Czech Republic	1,024	2,720	1,264	123	2
Hungary	1,097	4,410	1,986	195	4
Moldova	18	64	24 (60)*	13 (17)*	2
Poland	542	1,134	2,741	71	2
Romania	347	404	210	9	1
Slovak Republic	178	134	177	33	1
Slovenia	131	170	180	90	1
Ukraine	100	300	500	10	1

Source: Based on EBRD, *Transition report 1997*

* Data for 1996 are revised by MET. Data in brackets are for 1997.

Foreign trade

Table 6.1.5 presents an overview of trade specialization in transition economies by major products categories. Notably, the largest differences are between resources-rich economies with a very high share of raw materials and fuel exports and the rest. A high share of machinery and transport equipment in total exports is registered in exports of more developed East European countries, such as: The Czech Republic, Hungary and Slovenia. The lowest shares of machinery and transport equipment are in export of CIS countries. The main items of Moldovan exports remain agricultural products, chemicals and intermediaries.

The structure of imports is relatively uniform across the countries. Most of the countries remain net importers of food and agricultural products. The basic items imported in the region are chemicals, machinery and transport equipment.

Table 6.1.6 Structure of export, percentage share in total exports; 1995

Countries	Food, beverages, tobacco, and agricultural products	Raw materials except fuel	Fuels and electric energy	Chemicals and intermediates	Machinery and transport equipment	Other manufactures
Moldova	39.7	11.8	1.1	33.6	2.6	11.1

Source: Based on EBRD, *Transition report 1997*

Graph 6.1.2 Structure of export, 1995

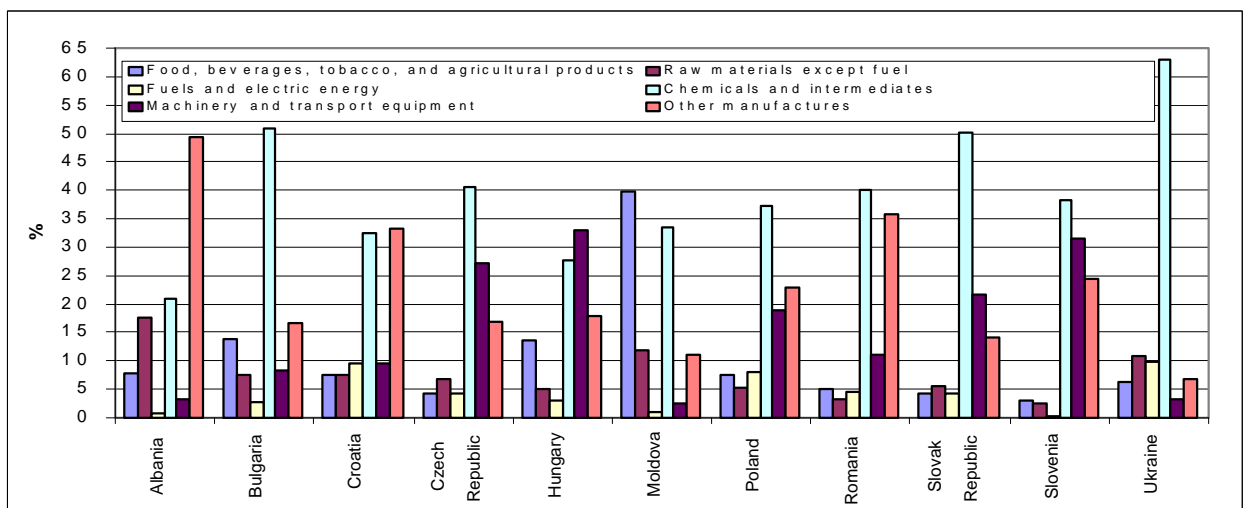
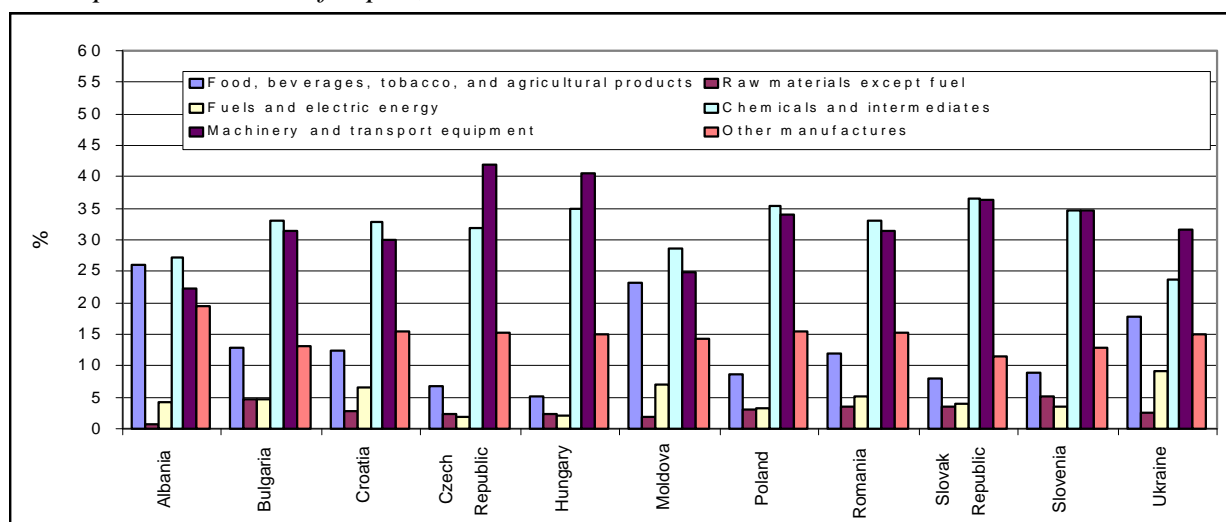
Source: Based on EBRD, *Transition report 1997*

Table 6.1.7 Structure of imports, percentage share in total imports; 1995

Countries	Food, beverages, tobacco, and agricultural products	Raw materials except fuel	Fuels and electric energy	Chemicals and intermediates	Machinery and transport equipment	Other manufactures
Moldova	23.1	1.8	7.1	28.7	24.9	14.3

Source: Based on EBRD, *Transition report 1997*

Graph 6.3 Structure of import, 1995

Source: Based on EBRD, *Transition report 1997*

6.2 Neighboring countries: Romania and Ukraine

Romania: the social-economic evolution in 1997-1998⁵

Romania – one of the transition countries ranks the twenty-ninth place among the European countries according to the economic freedom index⁶.

Index of economic freedom, 1997

	Trade	Taxation	Govern.	Monetary	Foreign	Banking	Wages /	Property	Regula-	Black
	sistem		intervent.	policy	investm.		prices	rights	tions	market
Estonia	1	3.5	2	4	1	2	2	2	2	2
Czech Republic	2	4	2	2	2	1	2	2	2	3
Latvia	2	2.5	3	5	2	2	2	3	3	4
Hungary	4	4	3	4	2	2	2	2	3	3
Poland	2	3.5	3	5	2	3	3	2	3	3
Lithuania	1	3	3	5	2	3	3	3	3	4
Slovak Republic	3	4.5	3	2	3	3	3	3	3	3
Slovenia	4	4	3	5	2	2	3	2	3	3
Romania	2	5	3	5	2	3	2	4	4	3
Moldova	3	3.5	3	5	3	3	3	3	3	4
Armenia	2	3.5	3	5	4	3	3	3	4	4
Russia	4	3.5	3	5	3	2	3	3	4	4
Bulgaria	4	4.5	3	5	3	3	3	3	4	4
Georgia	3	2.5	2	5	3	4	4	4	4	5
Ukraine	4	4	3	5	3	4	3	4	4	4
Belarus	4	4.5	3	5	4	3	4	4	4	5
Azerbaijan	5	4	5	5	4	4	5	4	4	4

Romania's transition process to the market economy has its particularities and is occurring in a relatively slight economic decline. Thus, according to the information of the National Statistics Committee, in 1997 the GDP reached lei 249,750.2 billion (US\$ 33.5 billion, coming to 87.1 per cent of the 1990th level (for the comparison, in Republic of

⁵ Sources: Ministry of Industry and Commerce, Romania's social-economic evolution in 1997; Chamber of Commerce and Industry of Romania; Social-economic objectives of the Radu Vasile Government's Program till 2000.

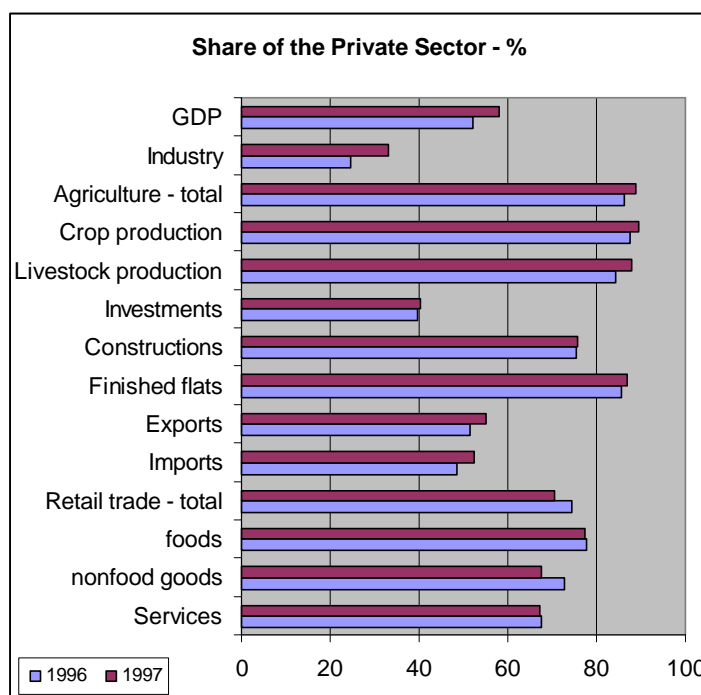
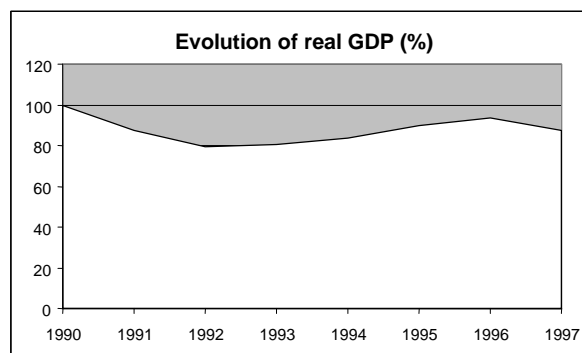
⁶ 1998 Index of Economic Freedom. Heritage Foundation Annual Report (USA)

Moldova this indicator amounts 36 per cent) and marking a 6.6 percent drop in comparison with 1996. *Industry and services*, contributing almost 70 per cent to the GDP, diminished in comparison with 1996, by 5 and 11.2 per cent respectively (by about 10 per cent -in the first quarter 1998 in comparison with the same period of 1997) . The situation of *agriculture* was characterized by two tendencies: a growth in plant cultivation by 10 per cent and livestock production diminishing by 7.1 per cent. Capital *construction* dropped in 1997 by 22 per cent in real terms.

This decline caused a reduction in the domestic demand by 8.5 per cent in comparison with last year and the a of the final consumption by 6.4 per cent. Activity of the *retail* enterprises during 1997 was developing under the direct influence of consumers' behavior and savings of the population, determined, on one hand, by the evolution of the buying capacity of incomes, and on the other hand, by the dynamics of interest rates for bank deposits. The total turnover of the sector diminished by 28 per cent in comparison with 1996. About 70 per cent of the total retail trade belongs to the private sector. As a consequence of these phenomena a

stocking process enlarged in the economy. By the end of the 1997 the *stocks of final products* amounted 58.5 per cent from the total output in December. Trade Services diminished in real terms by 19 per cent, the share of the private sector in services amounting to 67.1 per cent.

Foreign trade. In 1997, exports of goods amounted US\$ 8,428.9 million (4.3 per cent more than in 1996), which corresponds to a monthly average level of US\$ 702.4 million, over US\$ 673.7 million in 1996. The share of private sector in total exports amounted in 1997 to 54.8 per cent and grew up by 11.2 per cent over the 1996 (in the first quarter 1998 it diminished



	EXPORT - FOB (\$ mil.)		IMPORT - CIF (\$ mil.)	
	1996	1997	1996	1997
Agro-food products	706.9	594.8	869.9	694.4
Mineral products	692.1	637.9	2688.7	2408.4
Chemical	881.7	745.4	1433.9	1383.8
Textiles, confections, leather, shoes	2291.6	2551.3	1730.1	1998.2
Wood and papir industry	838.6	848.3	383.8	360.2
Construction materials, glass	150.3	151.4	144.5	142.9
Metal goods	1268.7	1556.4	715.3	669.9
Mashin building, electronics	1136.3	1209.6	3160.1	3234.1
Total	8084.5	8428.9	11435.3	11275.4

by 1.2 per cent). In the geographical structure of exports 56.8 per cent belong to the European Union. Imports constituted US\$ 11,275.4 million in 1997, or 1.4 per cent more than in 1996 (in the first quarter of 1998 it diminished by 8.3 per cent). The share of private sector in total imports comes to US\$ 5,520.7 million, or 48.3 per cent of the total import in 1996. In total imports, 52.1 per cent fall on the European Union. The Republic of Moldova is placed on the

twenty – first place according to the total volume of commercial exchange of Romania, the fifteenth place on exports side and the thirtieth place on the imports side. The total volume of exchange diminished in 1997 by 5.9 per cent, from which +27.8 per cent - exports and – 21.8 – imports.

Privatization of state property is underway. The degree of privatization (according to the criteria of the social capital) reached 100 per cent in 1997 in textiles, 90 per cent – food packaging, 89 per cent processing of plastic materials, 86 per cent – construction materials, 80 per cent – cement. The dynamic of privatization in industry and agriculture, traditionally considered to be problematic sectors for privatization, exceeded the dynamic of privatization in tourism and trade, branches normally more attractive for private investors. This change marks a movement of the private capital toward the productive sectors, which has a more durable profitability in time.

Investment in 1997 grew up to lei 38,364.9 billion, dropping in real terms by 19 per cent in comparison with 1996 (I quarter 1998 it diminished by 2.1 per cent). Private sector investments constituted lei 15,410.5 billion. More than a half of the total volume of investments was concentrated in a couple of activities: 11.9 per cent – transactions with the real estate, 11.2 per cent - agriculture, petrol and gas extraction – 9.6 per cent, food and beverage industries – 8.5 per cent, power, electric and thermal energy, gas and hot water production, transportation and distribution – 96.4 per cent, mail and telecommunications – 6.3 per cent. The fall of investments was caused, on one hand, by the deterioration of financial situation of the economic agents and, on the other hand, a restrictive monetary policy. Only 7.5 per cent of investments were financed through credits, own sources and those non-banking attracted (population's funds, extra-budget or allocated by the state property fund, foreign capital), continuing to be preponderant.

A situation more favorable than in the Republic of Moldova was created in the domain of the *state budget execution*, the revenues amounting to

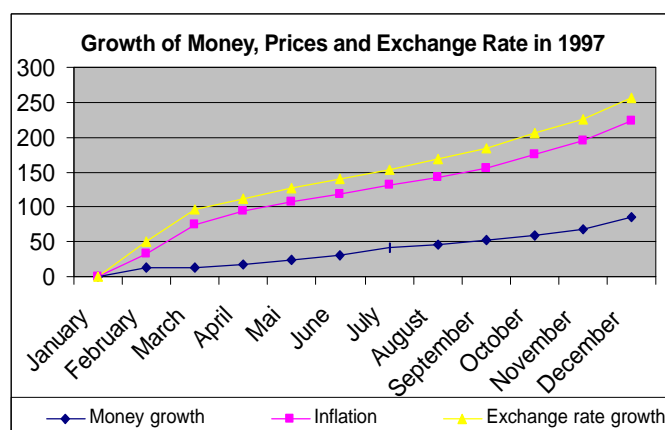
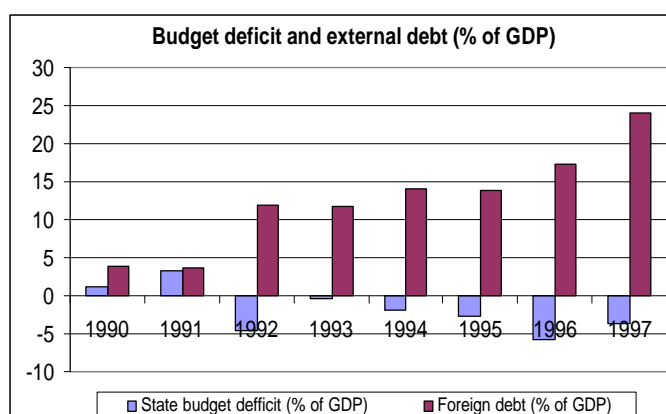
43,863.6, but expenditures - lei 52,933.7 billion, the deficit coming to 3.6 per cent of GDP.

External debt in 1997 reached 24 per cent of GDP (for comparison, in the Republic of Moldova – 64 per cent).

Monetary policy. The loosening of the control over the banking reserves, seasonal factors and measures made in the sphere of incomes, according to the official opinion, were the most important determinants of the monetary indicators' growth in the second half of 1997.

During the whole year broad money (M2) grew by more than 60 per cent, cash – by 75 per cent. This had its impact on the nominal *exchange rate* (from 4 thousand lei per US\$1 at the beginning of the year

till 8 - at the end and 8.2 at the end of first quarter 1998) and inflation (*inflation rate* in 1997 reached 151.4 per cent, and a monthly average – 8 per cent, compare to over 3.8 per cent in 1996). *Food consumer prices* grew up 1.46 times, prices for nonfood goods – 1.42 times, and services – 2 times. The average interest rate used by the National Bank of Romania at the end of the year stood at 52.6 per cent for credits and 15 per cent for deposits.



The number of the employed diminished in 1997 by 507 Thos. persons, the unemployment rate rising from 6.6 per cent in 1996 to 8.8 per cent in 1997 (9.3 per cent in I quarter 1998). In December 1997, the average nominal wage reached lei 1,265,671 (US\$ 170), marking a growth in nominal terms by 116.9 per cent in compared to 1996 which constituted 39.2 per cent in the total household's revenues. The buying capacity diminished to 86.3 per cent of the level of December 1996 and 64.4 per cent of 1990.

The forecast for 1998 is the drop in inflation rate to 37 per cent. Revenues of the public budget will amount 29.5 per cent of GDP, expenditures – 33.5 per cent of GDP, and the state budget deficit - 3.6 per cent of GDP. This level of expenditure from the public national budget is expected due to the realization of radical changes in the allocation of budget resources, among which are increased capital expenditures, the utilization of sources obtained from privatization for development programs, including the concrete projects, such as export promotion, the development of small and medium business, regional development.

Among the *social-economic objectives of the Government* are

- defining the state's role in the allocation of resources in case of the market failure, creation of an integrated system of markets;
- acceleration of the structural adjustment of the economy;
- reaching and consolidation of a macroeconomic stability, creation of conditions for the durable economic development;
- compensation of delays in the domain of social-economic changes necessary for the entrance in the European Union;
- regional and local development, growth of social unity;
- amelioration of adverse social consequences of economic reforms;
- re-launching of the social, interethnic, and interprofessional dialog at local and central levels, as well as supporting of the civil structure of the society, and participation of citizens and communities in the management and control of public affairs;
- improving of the image of Romania, growth in the attractiveness of the economy for foreign capital and re-launching of the efficient dialog with financial institutions, through the growth of public administration capacity in elaborating and implementing policies in all domains.

Ukraine at crossroads⁷

Five years behind the Central Europe

Ukraine is in a difficult economic situation. The expected economic growth in 1997 did not occur. Starting from 1991 the economy experienced a dramatic decline, the tempo of economic growth in 1997 having been by 55% less than in 1991.

The country is *at crossroads*: either it chooses a way to a proper sound development and becomes competitive, or, continues to operate within an ambiguous legal framework and receive assistance from abroad, which is not going to last very long.

Ukraine, according to western analysts, lacks *5 years behind* the Central European countries and 2 years behind Russia, as regards economic reform.

Should the structural and legal reforms be applied, the Ukraine could register a 1.5% economic growth in 1998 and even 2% in 1999. A good management and capital are required.

Vacillating privatization

⁷ M. Bratu. Ucraina la răscruce de drumuri. Tribuna Economică, 1998, nr. 26

Until 1997, *the privatization was vacillating*. The process of mass privatization launched in 1992 and relaunched in 1995 was based on coupons (vouchers). Half of state enterprises, including the small and middle ones, have been privatized.

However, these enterprises are *lacking capital and adequate management*. The big companies are still in state ownership, and need the same recipe of capital injection and management.

The Ukraine *has no legal framework that could attract foreign investors*. They are countered by the decisions of the authorities from Kiev. This happened with the American telecommunications concern Motorola that was hampered to extend in the Ukraine.

The result of the vacillating privatization in the Ukraine shows that this country attained *less than 1/3 of the planned incomes from the privatization process*, that were supposed to come into the state budget. Of the planned incomes in amount of US\$ 500 million, about US\$ 150 million were obtained.

The direct sales of enterprises this year will amount to about US\$ 1 billion, *i.e.* circa half of the total direct foreign investments in the Ukraine.

Foreign investors hesitate

The biggest foreign investor in the Ukraine is the South Korean Daewoo, which signed a joint-venture contract worth US\$ 1.3 billion, with Avtozaz - the largest car manufacture in the Ukraine. Also, the English-Dutch giant Shell invested more than US\$ 1 billion in the pipeline supply through the Ukrainian territory of oil and natural gas from Russia.

Ukraine might become attractive for foreign investors. With a market of over 50 million inhabitants and possibilities to invest in energy sector, chemistry, air transport and telecommunications, Ukraine might attain almost US\$ 10 billion from direct foreign investments, according to western analysts.

The major drawbacks that the Ukrainian economy faces are its lacking behind in the reforming process, ambiguous legal framework and tough taxation system.

The taxes and duties should be diminished, and government expenditures should be drastically curtailed. Some steps in this regard have been made through the law on profit tax and VAT introduction. Yet, this is the beginning and only the beginning.

The banking financial sector is fragile. The capital market is necessary and needs to be supported. For this purpose, and for economic growth as a whole, much money is needed. This money can originate from foreign investment of capital. This is the chance of Ukraine.

Ukraine needs to become out of a large potential market and of a potential remarkable economy an existing one.

The undercapitalized economic potential

Reality shows that the market potential of Ukraine is so large, that in commercial terms it is possible to do a good job in this part of Europe. The export towards Western Europe account for almost 16% of the overall Ukrainian exports.

The car manufacturer Avtozaz plans to export about 250.000 pieces per annum, particularly in Russia.

The Ukraine upkeeps close economic ties with Russia, venturing to lose some western markets.

Anyway, it can afford neither to lose the *western markets*, being in urgent need of capital nor lose economic links with Russia, being dependent of the natural resources from this country.

The Ukraine needs to gain trust of the western investors and creditors, both of those from London Club and Paris Club.